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Cover 1, p. 2,

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TRUSTS & ESTATES

ESTATE PLANNING & ADMINISTRATION

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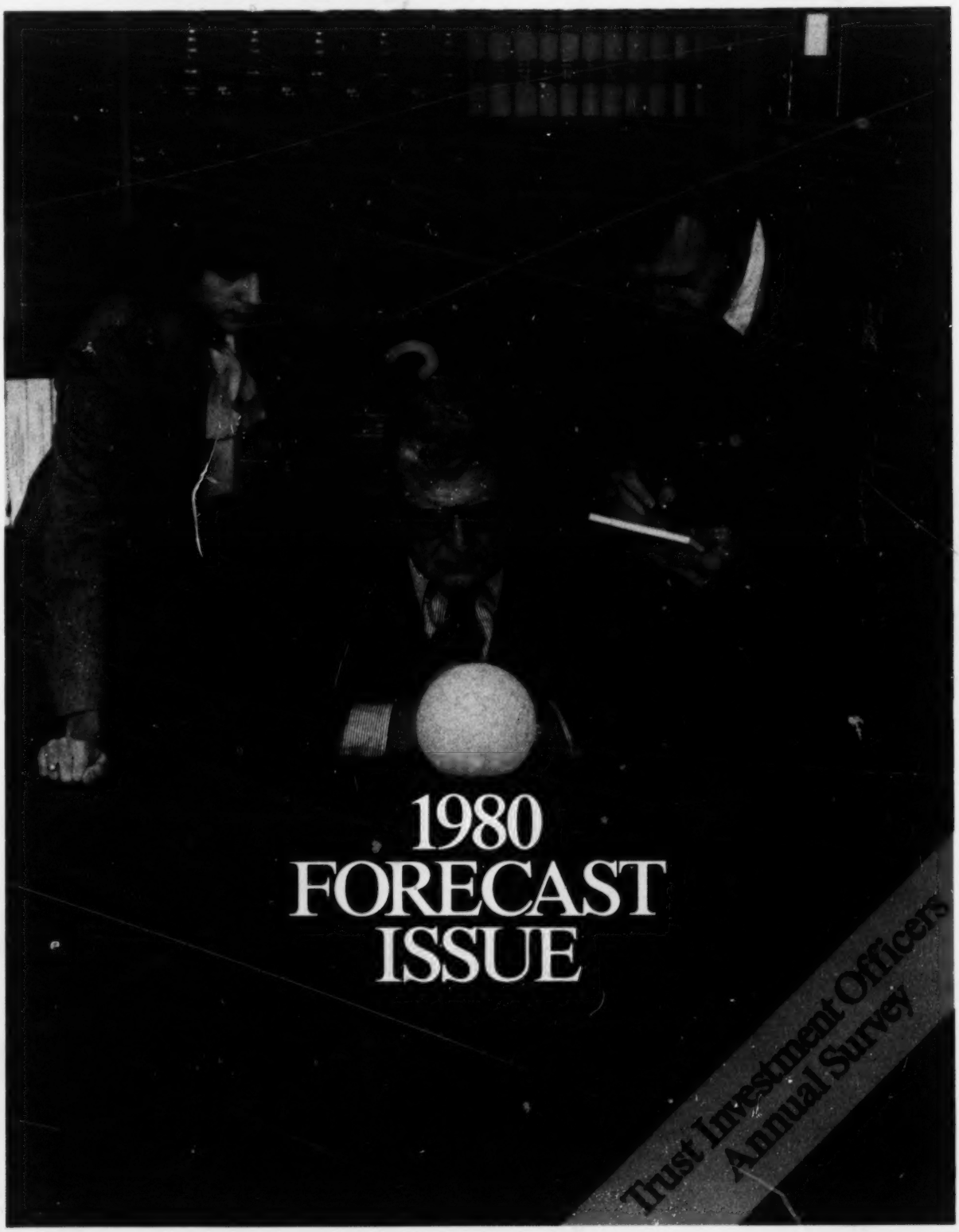

1980 FORECAST ISSUE

Trust Investment Officers Annual Survey

TRUSTS & ESTATES

Volume 119, No. 1 JANUARY 1980

Estate Planning and Administration Since 1904

12 **The Trust Business: An Industry at the Crossroad**
There's an urgent need for direction and innovation *John W. Heilshorn*

22 **Trusts & Estates 28th Annual Investment Officers Survey**
The key word is "uncertainty"

28 **Estate Planning and Administration in the 1980's**
Eleven estate planners predict trends of the next decade

46 **Why Invest Trust Funds in Collectible Stamps?**
A trust company executive who does explains why *Paul D. Kadavy*

52 **Diamonds: A New Appraisal for Estate Planners**
Returns are tempting, but the best advice is "caution" *George Adcock*

56 **Beyond Direct Mail — Marketing Personal Trust Services in a Community Bank, Part III**
The role of internal operations in a successful program *David B. Lantz*

62 **Another Look at Specialized Mutual Funds**
What are their uses in trust portfolios these days? *Peter W. Thayer*

67 **Avoid Tax Problems in Planning Recapitalizations**
A useful tool, recapitalization is not without its dangers *Peter L. Faber*

74 **Fiduciary Powers over Life Insurance: The Courts and IRC Section 2042(2)**
Recently, courts have offered different interpretations *Burke A. Christensen*

80 **Philanthropy and Estate Planning**
Olla Podrida of recent rulings *Conrad Teitell*

92 **Trusts & Estates 1979 Editorial Index**

COVER
The cover of this 1980 forecast issue depicts one of the less analytical means of predicting future trends. However, two articles included, "Estate Planning and Administration in the 1980's" and the "28th Annual Investment Officers Survey," provide a more rational appraisal of the decade ahead. Photo by Bill Coker.

REGULAR FEATURES

4 Editorial
8 Letters to the Editor
61 Meetings & Conventions
85 Wills of the Month
86 Institutional Investor
88 Fiduciary Decisions
90 Trust Personnel Changes

TRUSTS & ESTATES

28th Annual Investment Officers Survey

Will inflation remain above 12%? Will recession continue through 1980? What are the most promising industries in which to invest this year? Our survey sought opinions on these and other pertinent questions

Responses of trust investment officers throughout the U.S. to this year's survey reflect much of the same uncertainty that pervades many recent analyses of economic developments and trends. Despite innumerable forecasts in 1979 of an imminent (or existing) economic decline, a majority of respondents predicted that a recession would *not* continue through 1980. Similarly, according to the survey, there are almost as many trust investment officers who believe that unemployment will not rise above 8% this year as there are those who believe it will.

Admittedly, there is one shadow of uncertainty over the survey results themselves. Questionnaries were mailed in late August and early September to more than 100 trust institutions of various sizes in all 50 states. The deadline for returning the questionnaires was October 15. Many of the 60 trust executives who responded returned the questionnaire promptly, well before the deadline. Other forms were received almost exactly on deadline, and a few trickled in a few days later. On Saturday, October 6, the Federal Reserve Board initiated its new monetary policy in an effort to curb inflation, in the process sending interest rates on their latest upward spiral. The degree to which the Fed's action influenced the opinions of those who returned the questionnaires after October 6 or would have changed the answers of those who returned the form earlier cannot be determined.

The first six questions on the survey sought simple "yes-no" answers to general questions about the probable direction of the economy. Though, as mentioned before, the results were mixed, they were surprisingly optimistic. For example, asked whether a recession would continue through 1980, 59% of the respondents said it would not, while 41% thought it would. "Will inflation remain above 12% in 1980?" we asked next. Again, the optimists carried the majority, with 73% voting no; 27%, yes.

The level of consensus dropped considerably in the responses to the survey's third question: "Will unemploy-

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ment remain below 8% in 1980?" While 53% answered yes, 47% said no.

In response to a question on whether corporate profits would rise by more than 10% in 1980, an overwhelming 75% checked "No," compared with 25% who thought profits would top 10%. The question, "Will yields on long-term AAA corporates be tending up in 1980?" brought an almost identical reply: 77%, no; 23%, yes.

Optimists were again in the majority concerning the probable level of the Dow Jones industrial average this year. We asked, "Will the DJIA reach 1,000 in 1980?" In response, 67% agreed that it would, 31% thought it would not, and 2% gave no answer.

The next group of questions on the survey asked for specific estimates of movement in the Gross National Product (GNP), Consumer Price Index (CPI), after-tax percentage change in corporate profits, prime rate, the Dow average, and the percentage of new funds to be committed to common stocks in 1980. The range of responses to these questions is shown in the five tables at right.

A comparison of the answers to these questions on this year's survey with the answers to the same questions on last year's questionnaire offers a gauge of change (or lack of it) in the mood and expectations of the nation's trust investment officers.

Last year, nearly 60% (59.86) of the respondents indicated that the real gain in GNP during 1979 would be between 0.1% and 2.0%. This year as well, the 0.1-2.0% range drew more votes than any other category, but only 47% of this year's respondents predicted that degree of gain. The next category, 2.1-4.0%, was chosen by 33%, compared with last year's 36%.

Interestingly, this year 13% of those participating in the survey predicted that GNP would remain flat or decline, an option no one chose last year. Responses from those predicting a flat or declining GNP ranged from a simple "no gain" and "will decline" to more precise estimates of "−1.0 to −2.0%"; "0 to −1.0%; and "−1.5%."

The next question on the survey asked investment officers to predict the rise in the Consumer Price Index during 1980. The largest number of respondents (40%) picked 8.0-8.9% as the most likely range of increase. Last year, the 7.0-7.9% range topped the list, selected by 45% of the participants. The second most frequently selected category this year was "more than 9%," the first choice of 28% of the respondents.

In the 1980 survey, as in last year's, a plurality (23% this year, 37% last year) predicted that after-tax corporate profits would increase 3.0-4.9% in the next 12 months. However, this year an almost equal percentage (22%) forecast that the gain would be between 7.0% and 8.9%.

As in the answers to the question on real GNP gain, a number of trust investment officers predicted either no gain or a fall in the level of corporate profits after taxes. Our questionnaire listed 3.0-4.9% as the minimum rise. On their surveys, 2% of the participants wrote, "Less than 3%." That after-tax corporate profits would register "no gain" was the opinion of 3% of this year's survey sample. Others (13%) wrote that 1980 would see a decline in after-tax corporate profits. Estimates of the projected drop ranged from "decline 5% to "down 11-12.9%," with several forecasting a decline of around 10%.

Another question asked trust investment officers to predict where the prime rate would stand on June 30, 1980. Here, perhaps more than on any other question, the impact of the Fed's October policy shift may have colored the results of the survey.

A June 1980 prime of 10.5-10.9% was forecast by 20% of those who returned the survey questionnaire. Exactly the same percentage named 9.0-9.4% as the most probable prime rate range at mid-year. A range of 9.5-9.9% was the third most popular choice, selected by 15% of the respondents. Only 2% believed that the prime would exceed 13% at the end of June.

Last year, the greatest percentage (21%) predicted that on June 30, 1979, the prime rate would stand at 9.5-9.9%, while 18% expected to see it between 10.0% and 10.4%.

The Stock Market

Six of the final seven questions on this year's survey concerned the stock market. First, we asked the trust investment officers where they expected the Dow average to be on June 30, 1980. A subsequent question asked them to fix the level of the Dow on December 31, 1980.

At mid-year, said 28% of the participants, the DJIA should be between 900 and 949. That range received more votes than any other. Ranked second was the 950-999 category, selected by 20% of those surveyed. The graph on

Table I
1980 Gain in Real GNP

% Gain	% of Response
"Decline"	3%
−1% to 2%	5%
0 to −1%	5%
0.1-2.0%	47%
2.1-4.0%	33%
4.1-6.0%	3%
6.1-8.0%	2%
8.1-10.0%	2%

Table II
1980 Rise in Consumer Price Index

% Rise	% of Response
2.0-2.9	5
3.0-3.9	2
4.0-4.9	0
5.0-5.9	5
6.0-6.9	5
7.0-7.9	15
8.0-8.9	40
9.0+	28

Table III
Change in Corporate Profits after Taxes in 1980

% Change	% of Response
Decline	13
No change	3
Less than 3%	2
3.0-4.9	23
5.0-6.9	18
7.0-8.9	22
9.0-10.9	12
11.0-12.9	7
13.0-14.0	0
15.0-16.9	0
17.0+	0

Table IV
Prime Rate on June 30, 1980

Rate (%)	% of Response
8.0-8.4	3
8.5-8.9	7
9.0-9.4	20
9.5-9.9	15
10.0-10.4	12
10.5-10.9	20
11.0-11.4	8
11.5-11.9	5
12.0-12.4	8
12.5-12.9	0
13.0+	2

Table V
New Funds Committed to Common Stocks in 1980

% Funds	% of Response
0	3
1-20	17
21-40	20
41-60	45
61-80	15
81-100	0

"Interestingly, as we enter a Presidential election year and inflation and/or recession . . . dominate both news and conversation, neither politics nor the economy will be the most critical issue confronting the trust industry in 1980, according to the survey."

below traces the complete range of responses. Last year, a 29% plurality thought that on June 30, 1979, the Dow average would be between 850 and 899, while 28% believed it would stand between 900 and 949 on that date.

By the end of 1980, the Dow average will be in the 950-999 range, according to 33% of this year's participants. An optimistic 17%, the second highest concentration of responses, expect to see the average between 1,000 and 1,049. Last year, 29% of those polled, the largest percentage, predicted that on December 31, 1979, we would find the Dow average in the 950-999 vicinity.

We then asked what percentage of new funds would be committed to common stocks in 1980. A 45% plurality anticipate that common stock will receive 41-60% of new funds this year. The second most frequently cited estimate, endorsed by 20% of the respondents, was that 21-40% of new funds would go into common stock. These results nearly paralleled last year's responses to this question. At that time, 43% chose the 41-60% range, and 22% selected the 21-40% category.

Favorites

The last major block of questions on the survey asked respondents to list what they considered the five most promising industries in which to invest, the three most promising growth stocks, the three most promising income stocks, the three most promising long-term growth stocks, and the three most promising short-term income stocks. From these responses, we compiled lists of the ten most frequently mentioned stocks in each category. These lists appear in Tables VI-X on page 26.

Four of the industries included on last year's "most promising industries" list were repeated this year: energy (oil and gas), computers and high technology, office equipment, and chemicals. New additions were telecommunications, capital goods, retailing, aerospace and defense, health care services, and forest products. Those which appeared last year, but did not make this year's top ten were drugs, financial services, food, and insurance.

Among the favorite growth stocks cited by this year's sample, IBM and

Projected Level of Dow Jones Industrial Average

June 30 and December 31, 1980

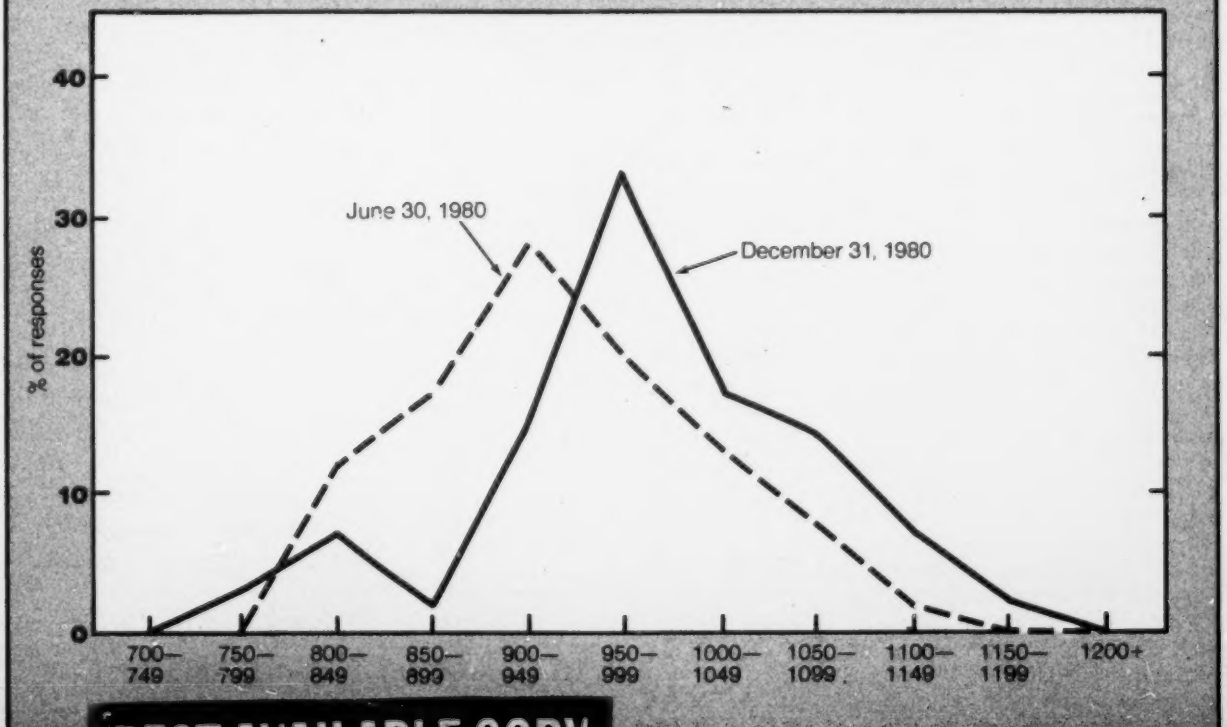

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Table VI
Most Promising Industries

Industry	% of Mentions
Energy (Oil & Gas)	78
Computers & high technology	41
Telecommunications	20
Capital goods	18
Office equipment	15
Retailing	13
Aerospace & defense	10
Health care services	8
Chemicals	8
Forest Products	7

Table VII
Favorite Growth Stocks

Company	% of Mentions
IBM	15 (1)*
Schlumberger	8 (2)
Xerox	7
Texas Instruments	7
Phillips Petroleum	5
Raytheon	5
Air Products & Chemicals	3
Atlantic Richfield	3
Baxter Travenol	3
Burroughs	3
Digital Equipment	3
Hewlitt Packard	3
Johnson & Johnson	3
Pepsico	3
Raychem	3
Santa Fe International	3

*( ) Ranking in last year's survey

Table VIII
Favorite Income Stocks

Company	% of Mentions
AT&T	33 (1)*
Exxon	10 (2)
IT&T	10 (10)
R. J. Reynolds	10 (4)
General Motors	8
Texas Utilities	7
Ford	5
Houston Industries	5
Tenneco	5
IBM	3
American Brands	3 (5)

*( ) Ranking in last year's survey

Table IX
Favorite Long-term Growth Stocks

Company	% of Mentions
IBM	35 (1)*
Schlumberger	18 (4)
Merck	8 (4)
Texas Instruments	8
Xerox	8
Phillip Morris	7 (3)
Baxter Travenol	5
Hewlitt Packard	3
Intel	3
Raychem	3

*( ) Ranking in last year's survey

Table X
Favorite Short-term Income Stocks

Company	% of Mentions
AT&T	13 (1)*
General Motors	8 (6)
Houston Industries	8
R. J. Reynolds	7 (4)
Southern Company	7
American Electric Power	5
Ford Motor Company	5 (7)
General Telephone & Electric	5 (5)
Texaco	5
Columbia Gas	3
Commonwealth Edison	3
Exxon	3 (2)
Tenneco	3

*( ) Ranking in last year's survey

Schlumberger were the only two which were also included in last year's list. The remaining eight from the 1979 survey — Smith Kline, Phillip Morris, Merck, 3M, United Technologies, Eastman Kodak, Millipore, and MacDonald's — were all replaced.

There were fewer changes this year among the group of "most promising income stocks." AT&T, Exxon, R. J. Reynolds, IT&T, and American Brands appeared on both the 1979 and 1980 lists, though in different order. Last year's choices which were eclipsed this year were Pacific Gas & Electric, Public Service of Colorado, Consolidated Edison, Duke Power, and Mobile Oil.

IBM, Schlumberger, Merck, and Phillip Morris, all of which were among the top ten "most promising long-term growth stocks" last year, remained on the list of favorites this year. For the third consecutive year IBM headed the list. Replaced this year were 3M, Pepsico, Digital Equipment, Dow Chemical, General Electric, and Smith Kline.

For the second year in a row, AT&T drew the most votes as the favorite "short-term income stock." General Motors, R. J. Reynolds, General Telephone & Electric, Ford Motor Company, and Exxon also made a second consecutive appearance on the list. Dropping out of the top ten favorite short-term income stocks this year were Mobile Oil, American Brands, Pacific Gas & Electric, and Southwestern Public Utilities.

The Most Important Issue

The survey's final question was, "What will be the most important issue confronting the trust industry in 1980?" Interestingly, as we enter a Presidential election year and inflation and/or recession seem to dominate both news and conversation, neither politics nor the economy will be the most critical issue confronting the trust industry in 1980, according to the survey. That title this year goes to "competition from other industries," cited by 17% of those answering the survey.

Inflation did concern enough trust investment officers to merit the second position on our list of most important issues. However, it demanded no greater concern than *profitability;* both issues were mentioned by 15% of the participants. *Regulation* (in which we included votes for the carryover basis controversy) was fourth on the list, with 13% naming it the most vital issue of the year. Rounding out the top five was *economy and recession,* a category mentioned by 5% of the survey respondents.

Many answers we received to this final question did not fit neatly into any of the five categories above. Nevertheless, the answers revealed a number of interesting expectations trust investment officers hold for 1980. Among these comments were the following:

- "To become flexible enough to meet the changing needs of existing trust clientele and to develop a program tailored to the needs of small estate holders at a reasonable cost."
- "The need to offer specialized investment products other than traditional stocks and bonds."
- "One issue which might be highlighted by financial market conditions would be the possible distortion of trust company investment practices by the necessities of competition."
- "Investment in stocks versus precious metals during an unnerving election year."
- "Re-evaluating the "prudent man" rule."
- "The deterioration of market prices of trust assets (specifically, the Dow Jones average)." □

Why Invest Trust Funds in Collectible Stamps?

Recently, a Nebraska trust company established a new "Philatelic Service." In this article the man who proposed and implemented the program explains the reasons behind it.

BY PAUL D. KADAVY
Executive Vice President
First Northwestern Trust Company
of Nebraska
Hastings, NE

Certainly, one of the most satisfying opportunities for any trust institution is to offer a new service to the public. We all know that in our business this occurs only rarely. It is particularly satisfying when (1) the new service is not available at other trust institutions, (2) it offers an opportunity to meet a need that is not being met elsewhere, and (3) the offering of the service produces substantial income at low cost for the trust institution. With the offering of our "Philatelic Service" at First Northwestern Trust Co. of Nebraska, we feel we have achieved these objectives.

In a way the idea behind this service occurred almost by accident. I have been a collector of world-wide stamps since childhood. In 1972 I began to realize that the older United States postage stamps were growing in value at a rate which outpaced the performance of traditional investments. This was true for the values reported by Scott Publishing Co. catalog, considered to be the stamp collector's bible. In researching the history of Scott catalog values for older U.S. stamps, I found the prices had been going up in steady progressions for decades. It was at that time I decided to become more advanced in my collecting, not only in terms of dollars spent (it was now not just a fascinating hobby, but also an investment), but also in my knowledge of U.S. philately. A continual review of auction price realizations at the major stamp auction houses throughout the country was essential to develop a feel for the philatelic market, especially since there are many different grades of quality for each stamp issued, which greatly affect value. The time commitment was substantial as were the rewards.

In March 1979, a customer of The United States National Bank of Omaha, an affiliate of our trust company, was referred to me by a bank officer because of the common interest which the customer and I had — namely, collecting investment-grade U.S. stamps. The customer showed me an item which had been purchased that day from a dealer. It was a never-hinged plate block of six of a popular U.S. stamp, which was in very fine condition. The price which the customer had paid for the block was $1,500. It was immediately clear to me — although I did not relate this to the customer — that I could have purchased a block of the stamp with the same qualities at a major auction house for $1,150, charged a 5% to 10% fee, and still have saved the customer well over $200! This specific incident laid the groundwork for the development of First Northwestern's "Philatelic Service." In thinking this through, there seemed to be other reasons for offering such a service:

- The customer, through our purchases at major auction houses, would have access to high-quality rarities that would typically be unavailable locally in the dealer market.
- Perhaps the general public, not just collectors, would be interested in investment-grade stamps when told about the potential returns.
- Perhaps holders of Keogh plans, IRAs and other employee benefit plans would want to make use of philatelic investments in view of the emphasis on performance in these plans.
- Perhaps this service would give us greater access to younger people because the higher commissions would allow us to accept smaller accounts. By doing business with the younger set today, we would not risk losing them to another offerer of trust services in the future after they have accumulated larger estates.
- Through our knowledge of philately, we would expect to be named in more estate plans which contain substantial collections and investments in stamps.

Expertise Necessary

After several months of planning, I was able to establish the procedures necessary to begin offering the service. Approval was given by management and the Board of Directors to begin this service on a pilot-project basis. That approval was obtained because of the opportunity to offer a new service and the potential income from it, the history of price performance in the philatelic marketplace compared with traditional investment returns, and the availability of in-house expertise to administer and monitor the program. I emphasize the latter because, in the August 1979 issue of TRUSTS AND ESTATES, it was stated that David Lee of Clayton Trust Company felt such philatelic expertise was not necessary

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since his company's function was strictly custodial.

The structuring of our service is far different. I am quite sure that Dave Neely, the President of our company, would not have approved the offering of this service without expertise on the staff. That was considered crucial. We do our buying at major auction houses throughout the country and with dealers who have established national reputations. It may be that one of the reasons the philatelic investment market for IRA, Keogh, and other accounts has not materialized is that the investor expects the trust institution to have the expertise to serve as the back-up to the dealer who buys the stamps for his portfolio. This concern is very real when one knows, for example, that a used 1847 5¢ Franklin sells for over $2,000 in superb condition, whereas a faulty copy would sell for under $300. To the unknowing trustee, the differences are not readily noticed.

A purchaser of stamps has things to think about that the Trust Investment Department has never heard of. Where and how you spend your stamp dollars is critical. How well the stamp is centered, the condition of the gum, whether repairs have been made, the condition of the perforations, the richness of color, and many other factors determine the price of a stamp and its desirability from an investment standpoint. Acting strictly as a depository offers the investor no such safeguard. We have had no difficulty in attracting investment accounts since our service began, some of them for six-figure amounts. We would not want, however to take a philatelic account where our only role was that of a depository.

Use of Agents

Even with my experience in the philatelic marketplace, it has been necessary for us to make use of agents to assist us in our continual buying program. It would otherwise require my full time to attend the auctions and meet with dealers who have access to high-quality material. This would be impractical and expensive and, fortunately, is unnecessary. Through David E. Blair, President of Continental Auctions, Inc. of Chicago, we have had access to major auctions and to large dealers. When buying for us, Mr. Blair has purchased top quality material and rarities that our trust company might not otherwise know was for sale. Through private transactions with other dealers, he has been able to receive dealer discounts, which in cases are substantially larger than fees paid for his services. Such discounts would not be available to us as a non-dealer. He either attends major auctions or is represented by others who have an opportunity to examine material before the auction. This offers a considerable advantage over mail bidding, which is, at best, uncertain in terms of the results and may often necessitate returned lots when the bidder does not have the opportunity to view the lots before the auction. All lots purchased through this arrangement are also examined by us for quality and correctness of pricing. I would recommend such an arrangement to any trust institution which may consider offering this service. Yet, the importance of back-up expertise in-house is in no way lessened by such an arrangement. Many times, our decisions are made as a result of joint deliberations and close scrutiny of rare items. The fiduciary, even if under direction, cannot totally be relieved of the responsibility for quality decision-making. And that fact seems to me to create a case for specialized knowledge in the trust industry as has occurred in the medical and legal professions. Philatelic knowledge is but one small example. Other tangibles present valid investment opportunities, assuming the skills are available within the trust institutions to administer them. I think that, without these and other specialized skills, we don't really serve the customer to the extent he needs. We should deserve more as trust institutions than to acquire new business which is solely custodial in nature because a law requires someone to use us.

The historical price appreciation in investment-grade stamps (in collectibles generally for that matter) has been so favorable in relation to traditional investments that it can no longer be ignored. Most people familiar with philatelic investments would acknowledge that investment-grade U.S. stamps have appreciated by 15% to 20% compounded annually for the past 10 years and about 60% for the past two years. That pace continues today. Because of the accelerating rate of appreciation, questions are being asked whether the largest increases have already occurred and if prices may begin to plateau or even to decline. In my opinion there are several factors which bode well for a continuing increase in the prices of quality postage stamps, regardless of economic conditions:

- There is a firm and steadily growing base of collectors in this country who need to acquire stamps for their collections. This built-in demand has always provided great stability and gradual upward pressure to prices of stamps. Stamps bought for collections tend to disappear from the market for many years. This base of collectors is further built by the U.S. Postal Service, which spends millions of dollars annually on T.V. and magazine advertising to promote stamp collecting. Although this advertising is intended to promote sales of new issues (which of-

Value of Selected U.S. Stamps: 1940-1979

Scott Catalog Number	Description	1940	1964	1972	1974	1979
1	1847 red brown	$ 40	$ 125	$ 400	$ 450	$ 1,200
2	1847 black	150	375	1,850	2,750	8,500
3	1875 reprint of #1	10	85	235	250	750
4	1875 reprint of #2	12	115	325	375	900
112-122	1869 pictorials	420	879	2,708	3,460	7,505
230-245	Columbian issues	240	674	2,486	2,963	7,588
285-293	Trans-Mississippi issues	121	360	1,099	1,421	3,164
294-299	Pan-American issues	13	43	102	142	366
300-313	1902-03 regular issues	128	358	810	980	2,714
401-404	Panama-Pacific (Perf. 10)	56	140	373	446	1,000
424-440	1914-15 Single line Wtrmk.	67	158	314	353	986
523-524	1918 $2 & $5 Franklins	35	100	180	205	800
551-573	1922-25 regular issues	24	64	134	189	579
630	White Plains Souv. Sheet	7	72	125	160	450
C1-C3	First Airmails	7	34	92	140	310
C4-C6	Second Airmails	6	30	76	119	267
C13-C15 & C18	Graf Zeppelin issues	47	316	700	835	3,050
		$1,384	$3,656	$11,324	$14,453	$38,031

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fer virtually no investment appeal), there is bound to be favorable carryover for investment grade material.

• The supply of investment-grade stamps is absolutely fixed and cannot be increased except by fradulent means. For such items where there may be a concern, the expert committees of the Philatelic Foundation in New York and others will issue a certificate of genuineness for a fee if the item is, in fact, genuine. All major auction houses and dealers will accept the return of any item found not to be genuine by such an authority. Actually, the supply of investment-grade stamps is decreasing since some continue to be lost or reduced in value through fire, mishandling and other means.

• Traditional investments on a total return basis have lagged so greatly behind philatelic investments and other collectibles in the past ten years that a continually increasing flow of new money from investors into stamps, both in the United States and abroad, has occurred with even broader implications. Now pension funds, wealthy doctors, lawyers and businessmen are bidding for and buying substantial quantities of rare stamps. Even securities brokerage firms are seriously thinking about or are preparing to enter the market for philatelic investments and other collectibles which have demonstrated strong performances. I expect to see more trust activity also.

Annual Compounded Increase In Value of a Selected Set of United States Stamps

Scott Catalog Number	Description	last 39 years	last 15 years	last 7 years	last 5 years
1	1847 red brown	9%	16%	17%	21%
2	1847 black	11%	23%	24%	25%
3	1875 reprint of #1	12%	16%	18%	25%
4	1875 reprint of #2	12%	14%	15%	19%
112-122	1869 pictorials	7%	15%	14%	16%
230-245	Columbian issues	9%	17%	17%	21%
285-293	Trans-Mississippi issues	9%	15%	14%	18%
294-299	Pan-American issues	9%	15%	17%	21%
300-313	1902-13 regular issues	8%	14%	18%	22%
401-404	Panama-Pacific (Perf. 10)	7%	14%	14%	18%
424-440	1914-15 Single line wtrmk.	7%	13%	16%	23%
523-524	1918 $2 & $5 Franklins	8%	15%	23%	31%
571-573	1922-25 regular issues	8%	15%	23%	25%
630	White Plains Souv. Sheet	11%	13%	20%	23%
C1-C3	First airmails	10%	16%	19%	17%
C4-C6	Second airmails	10%	15%	20%	17%
C13-C15 & C18	Graf Zeppelin issues	11%	16%	20%	28%

• Records of stamp price increases are more widely available than for any other type of collectible because of the catalogs of the Scott Publishing Company which has been in the business since the 1880's and because of published auction realizations.

• Because of the Department of Labor ruling on January 23, 1979, institutions such as ours will find it easier to invest in collectibles and other investments which prior to the ruling did not meet the standards of prudence under ERISA. This ruling seems to be a verbalization of a change in customary law which had already taken place;

• For individuals with substantial resources who can do without cash flow on a part of their resources, philatelic investments offer some interesting tax treatment. There is no income tax consequence until the stamps are sold, and then at capital gain rates if held longer than one year. The investor can time his sales to his best tax advantage. In a way, it is like a tax shelter.

Problem Areas

In spite of all these strong underpinnings which support philatelic investments and have driven prices increasingly higher, there are some problem areas that could conceivably have an effect upon this scenario of upward price movement.

If borrowings by investors to purchase stamps start playing a significant role in the total trade in investment grade stamps, for example, it would be a plus for stamp prices in the short term but a definite minus for longer term stability. Just as margin calls depress the securities markets, a wave of selling headed by leveraged investing in stamps would cause peaks and valleys in stamp prices which would add an element of uncertainty not encountered by stamp investors before.

If the ratio of investor to collector purchases increases dramatically, it would add a further element of uncertainty to the market in that investor stamp portfolios tend to be resold much more frequently than a collection painstakingly built over a period of many years. Thus, the supply factor in a market would be affected because of velocity.

If hustlers who prey on the unwary become a significant factor in the marketplace, confidence in the investment medium itself could wane. Of course, a personal knowledge of philately is the best guard against this. However, investors in anything can be lured by the prospects of large returns in investments they know nothing about. Caveat Emptor applies in such transactions, so the watch-word is to know those with whom you are dealing.

Although I would be the first to admit that there is some increase in each of these negative factors, I also feel strongly that it has not reached the point of causing any jeopardy to the philatelic marketplace, nor is it likely to do so in the foreseeable future. Pro-

fessionals in this business are mostly a very honest group, with a great deal of integrity in their dealings with their customers. Members of the American Stamp Dealers Association, the Philatelic Foundation, the American Philatelic Society, the Society for Philatelic Americans and other worthwhile philatelic groups are determined to keep philately as a hobby and as an investment under self-regulation through their own organization. This is free enterprize at its finest, in my opinion, and it works. Clearly too, if any of these negatives become significantly burdensome, the tell-tale signs will be easily read in the formative stages by professionals in the business and those knowledgeable in philatelic investments.

Philatelic Technology

One of the really positive developments in philately today is that technology is bringing it into modern times. The S/Mart Teletype system developed by Itel Corporation allows dealers and investors to have immediate access to buying and selling information across the country from other participants in the system. Also, video tape recorders are being used by such professionals as Myron Kaller, President of Myron Kaller & Associates, Inc., who invests in stamps for substantial clients. Instead of the time-consuming and expensive process of sending rare stamps to prospective buyers through registered and insured mail, a color video tape is sent along with commentary about the lots that the buyer is viewing on the tape. In addition to these developments, computer software packages will certainly arrive which will provide the investor with up-to-date pricing information, whereas information on prices realized at auction now are seldom available until weeks after the auction has already taken place.

Computer programs for accounting and pricing will eventually dovetail to provide individual portfolio valuations for annual or more frequent review purposes. The accounting is much more onerous for investments in stamps. Records must be kept of each lot by catalog number, exact description and cost basis with adequate tracing for audit purposes. New computerized accounting systems should help to encourage others to offer this service who have otherwise avoided it due to the need to establish alternative manual record-keeping procedures, such as ours. We hope to be involved in developing such a system.

With all of this sophistication entering into the picture, what impact will the institutional investor have upon the philatelic marketplace? The entire stamp trade in the United States is probably about two billion dollars per year. For high-quality investment-grade stamps, it is only a fraction of that figure. This contrasts with the securities and commodities markets which account for several trillion dollars per year.

If traditional investments continue to show performance below levels of inflation, it is safe to say that some small fraction of the trillions of dollars will be transferred to the philatelic marketplace and other collectible markets. In comparing the relative sizes of these different markets, a dramatic upward effect upon investment-grade stamp values is obvious if even a very small fraction of funds are moved out of the traditional marketplaces. Our trust company plays a small role in this. If we buy several million dollars in stocks and bonds, it is miniscule compared to the billions of institutional dollars which flow to such

assets. In the philatelic marketplace, however, it plays a greater role.

Although not a major factor in determining prices, we are in effect another supporter of firm prices, and each institution which enters the stamp market does the same. We are like new collectors; however, the game is different and the dollars are larger. I doubt that the investment-grade philatelic market can absorb more than 15 to 20 million dollars per year above and beyond the present levels. There is simply not that much more quality material for sale. Therefore, those dollars could only mean one thing: much higher prices for the stamps in the available supply.

Although a thorough knowledge of philately requires years of study and exposure through others knowledgeable in the field, philately as an investment is extraordinarily simple. The theories which analysts develop to make common stock selections are totally foreign to the philatelic marketplace. The market for rare stamps is for the most part a pure demand/supply relationship. Investment-grade stamps have no "value" other than as postage — unless someone decides to pay more for them. □

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Kadavy holds Bachelor's and Master's degrees from the University of Nebraska — Lincoln and is a trust major graduate of the Southwestern Graduate School of Banking at SMU. Mr. Kadavy teaches trust and estate planning courses at several schools and is an active member in the Omaha Estate Planning Council. He is also a member of the Philatelic Foundation, American Philatelic Society and Society for Philatelic Americans.

NOTE

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Cover 1, p. 2,

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TRUSTS & ESTATES

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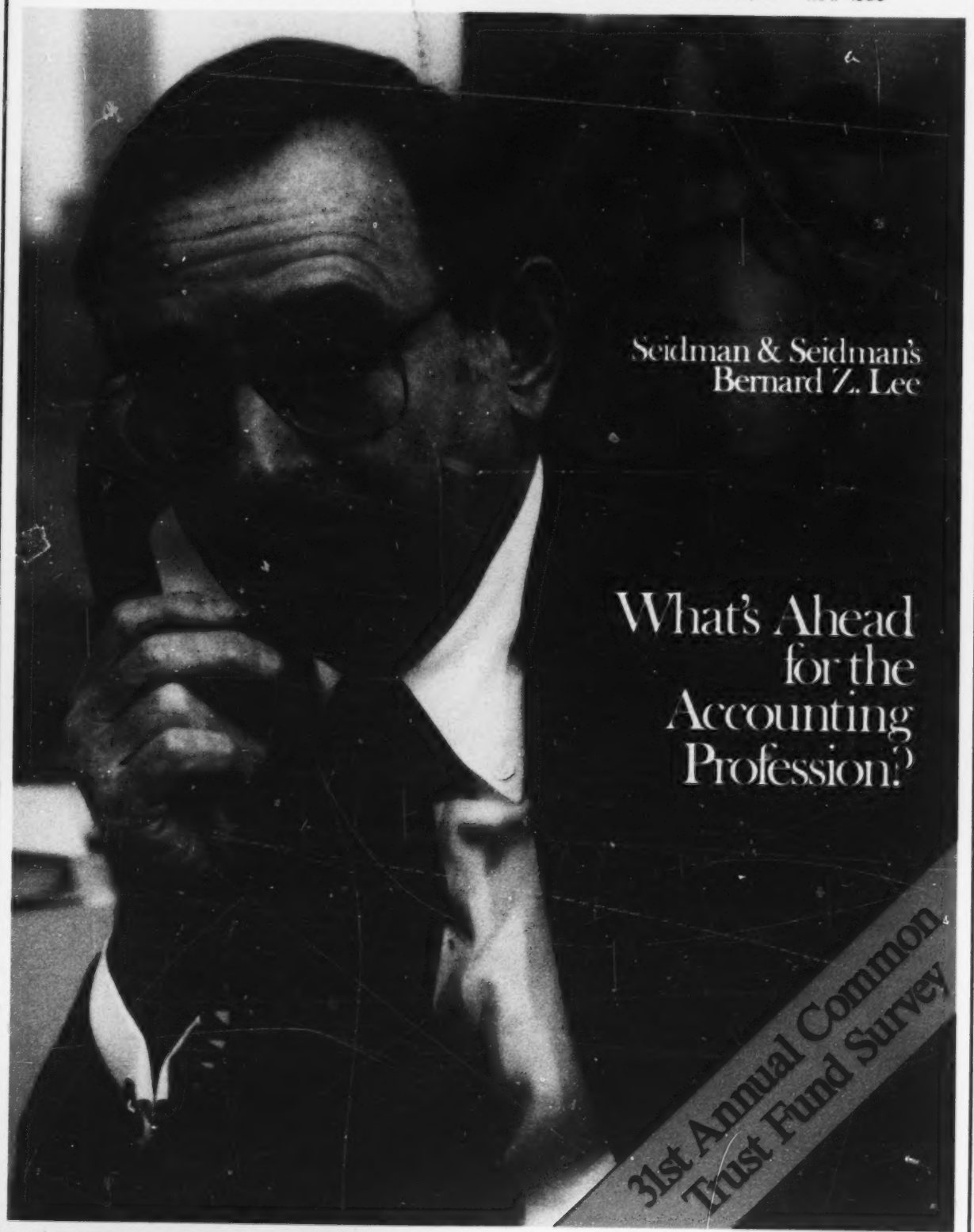

Seidman & Seidman's Bernard Z. Lee

What's Ahead for the Accounting Profession?

31st Annual Common Trust Fund Survey

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TRUSTS & ESTATES

Volume 119, No. 5 MAY 1980

Estate Planning and Administration Since 1904

10 / **Trusts & Estates' 31st Annual Common Trust Fund Survey**
Short-term investments play a more prominent role

30 / **What's Ahead for the Accounting Profession?**
Greater recognition and demanding new responsibilities *Bernard Z. Lee*

37 / **How Many Portions Are There in Corpus?**
Comments on withdrawal of Clifford trust capital gains *Joseph Ginsburg*

39 / **Computerized Estate Planning: An Accountant's Perspective**
Consider both advantages and disadvantages *Bruce W. Curtis*

42 / **A Picture Is Worth . . .**
Rare photographs as an estate asset and potential investment *Richard Boling*

49 / **In Search of Missing Heirs: The World of Forensic Geneaology**
There are more lost beneficiaries than you might think *Carolyn Mathews*

54 / **Federal Estate Tax Deferral: New Challenges for Fiduciaries**
Recent IRS rulings have added new considerations *Marc P. Blum and Charles E. Bienemann, Jr.*

61 / **Managing Employee Benefit Plans through Automation**
If you can't find the right system, develop your own

64 / **Philanthropy and Estate Planning**
IRS collapses contribution tax shelter *Conrad Teitell*

COVER

During the 1980's the accounting profession faces several critical issues, such as the need to develop an equitable system of self-regulation and to meet the challenges of automation. In our cover story this month, Seidman & Seidman's Bernard Z. Lee comments on these and other topics. "What's Ahead for the Accounting Profession?" begins on page 30.

REGULAR FEATURES

2 Editorial
6 Letters to the Editor
60 Meetings & Conventions
66 Law and Life Insurance
68 Recommended Reading
69 Personnel Changes
72 Fiduciary Decisions

TRUSTS & ESTATES'

31st Annual Common Trust Fund Survey

As the economy has grown increasingly volatile and unpredictable, our survey results indicate, common trust funds, not surprisingly, have committed more of their assets to short-term investments

by **RICHARD BOLING**
Editor
and
SHARON MATHIS
Research Director

Institutions administering common trust funds committed a larger percentage of their fund assets to short-term investments in the past year. Not surprisingly, while interest in short-term commitments has risen, the percentage of assets invested in corporate bonds dropped significantly. What is surprising is that the percentage of assets committed to common stocks also declined. These were among the findings of TRUSTS & ESTATES' 31st Annual Common Trust Fund Survey. More specifically, the survey results also suggest that, in a volatile and uncertain economic environment, many fund managers have begun seeking greater diversification in their common stock holdings.

The results of this year's survey was based on the annual reports of 456 funds at trust institutions across the U.S., a sample 19% larger than last year's. A table detailing the distribution of these funds acccording to asset size is provided on page 00. Interestingly, this year's sample contained a significantly larger percentage of funds with holdings worth over $100 million. Nearly 7% (6.7%) of the respondents this year fell into that category, compared with 2.8% in 1979. This higher percentage of large funds, together with the inevitable effects of inflation, also accounted in part for the dramatic rise in the value of the combined assets of all reporting funds, from $6.6 billion in 1979 to $11.9 billion this year.

The 31st Annual Common Trust Fund Survey also marks the return of a feature which was omitted last year, the high and low price quotes for the "Favorite Fifty" stocks during 1979. These statistics were drawn from *Standard & Poor's Stock Reports* and have been restored as part of the survey at the request of a number of readers who found this information interesting and valuable.

The Favorite Fifty

The top five stocks in the "Favorite Fifty" rankings last year remained in the five leading positions this year as well, although in slightly different order. IBM has retained its hold on first place for a decade, its overwhelming popularity among fund managers evidenced by the fact that 91% of the surveyed funds which hold common stock own shares of IBM. For the second consecutive year, AT&T took second place in the poll. Kodak dropped from third to fifth place this year, while Exxon and General Electric each moved up one slot from their 1979 positions to fill the third and fourth places this year.

Interestingly, many stocks which appeared in both the 1979 and 1980 lists maintained their positions or even rose in the rankings this year, even though a smaller percentage of reporting funds held the stock. For example, Atlantic Richfield, which was sixth in the rankings both years, was held by approximately 14% fewer funds in 1980. Similarly, Phillips Petroleum retained the fourteenth spot in the rankings though only 32% of the funds holding common stock this year held Phillips shares, compared with 41% last year. This may indicate a movement toward greater diversification of common stock holding among some fund managers. Indeed, the survey also revealed a decline in the percentage of funds holding stock in many of the "industry leaders" not listed in the top fifty.

Among the newcomers to the "Favorite Fifty" list were McDonald's, General Mills, and Deere &

The Favorite Fifty

Rankings of Common Stocks held by Surveyed Funds

Stock	Rank 1980	Rank 1979	Rank 1978	No. of Funds Holding	Shares Held (000)	1979 Stock Data High	1979 Stock Data Low
IBM	1	1	1	219	1,791.4	80-1/2	68-1/2
AT&T	2	2	3	180	1,423.1	64-3/4	57
Exxon	3	4	2	170	1,428.4	55-3/4	48-3/4
General Electric	4	5	4	154	1,005.4	51-5/8	45-1/2
Eastman Kodak	5	3	5	115	582.3	66-7/8	52-7/8
Atlantic Richfield	6	6	14	105	753.4	69-3/4	56
Minnesota Mining & Manufacturing	7	20	7	99	556.4	66	52-1/4
Standard Oil of Indiana	8	10	9	95	608.8	69	53-1/2
Xerox	9	17	16	88	431.3	62-7/8	52-5/8
Merck	10	11	10	84	481.3	71-5/8	62-1/2
Caterpillar Tractor	11	9	21	79	387.4	62-7/8	53
American Home Products	12	13	12	77	778	28-5/8	24-3/8
Phillip Morris	13	24	20	76	547.7	37-3/8	31-1/8
Phillips Petroleum	14	14	15	75	809.6	40-3/4	29-1/2
K-Mart	15	27	18	73	729.9	28-5/8	22-1/2
Mobil Oil	16	23	26	72	755.3	44-3/8	34
Dow Chemical	17	8	11	72	536.5	29-5/8	24-3/8
General Motors	18	21	6	71	513.3	61-3/4	53-1/8
Burroughs	19	15	23	68	221.1	78	64-3/4
Coca Cola	20	28	27	66	548.1	46-1/8	36-1/2
R.J. Reynolds Industries	21	34	45	66	353.6	60-5/8	54-1/2
Emerson Electric	22	—	33	64	452.7	39	32-1/4
Citicorp	23	7	17	63	579.2	26-5/8	22-1/2
Sears, Roebuck, & Co.	24	12	8	62	703.5	21-7/8	18
Schlumberger	25	16	28	62	399.9	86-3/8	61-3/4
PepsiCo	26	39	—	60	504.6	28-1/2	21-7/8
Proctor & Gamble	27	18	13	60	250.2	89-3/4	72-3/4
Conoco	28	—	31	57	443.5	41	28
Colgate Palmolive	29	33	37	54	633.3	19-5/8	15-3/4
Texaco	30	26	29	54	500.5	29-3/8	23-5/8
Union Pacific	31	48	32	53	320.8	70-3/8	51-1/2
E.I. DuPont de Nemours	32	36	23	53	250.7	48-1/4	41-3/8
Beatrice Foods	33	30	42	52	789.2	24	20-1/8
General Telephone & Electronics	34	—	36	51	409.8	30-3/4	27
Warner Lambert	35	50	—	50	508.2	26-1/2	21-1/2
Johnson & Johnson	36	49	38	49	234.8	77-3/8	67-3/8
Pfizer	37	40	—	48	327.5	35	29
BankAmerica	38	41	49	44	590.2	27-1/8	24
Mc Donald's	39	—	—	44	386.1	51-3/4	39-1/4
American Express	40	25	30	44	359.5	36-1/8	28
J.C. Penney	41	32	41	44	356.1	33-3/8	28
Avon Products	42	42	—	43	412.8	56	45-5/8
Halliburton	43	22	19	43	218.9	80	59-3/4
International Telephone & Telegraph	44	—	51	41	531.1	30-7/8	27
Texas Utilities	45	37	46	40	523.8	20-1/8	18
Abbott Laboratories	46	43	—	40	430.8	36-1/4	29-1/2
Weyerhauser	47	19	24	39	309.2	32-7/8	24-1/2
General Mills	48	—	—	39	234	30-3/8	23-7/8
Kraft	49	—	44	38	264.7	48-3/4	43
Ford Motor Co.	50	44	—	37	316.2	45-3/8	39-7/8
Deere & Co.	51	—	—	37	282.7	38-7/8	33-1/4
Union Carbide	52	38	47	37	182.2	40-3/4	34

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Co. The most spectacular debut was made by Emerson Electric, which, after dropping off the list last year, vaulted to number 22 in our most recent survey. General Telephone & Electronics, International Telephone & Telegraph, and Kraft also returned to the list after a year's absence.

Stocks disappearing from the rankings this year included Bristol Meyers, Schering Plough, Smith-Kline, Revlon, Tenneco, and International Paper. The latter registered the most dramatic fall, dropping off the list from the 29th position in 1979. This year's poll also reflected several precipitous declines among stocks which remained among the top fifty. Most notable among these was Weyerhauser's plunge from 19 last year to 47 in the 1980 rankings.

Common Stock Funds

Equity funds formed a smaller percentage of the 1980 survey than they did in 1979 (44% last year, 36.8% this year). Analysis of changes in the asset mix of these funds revealed a number of correspondences between trends in common stock fund investment and the general data for all funds, particularly in the new, heightened emphasis on short-term investments.

While the percentage of equity fund assets committed to common stock declined 4% from last year's level, the percentage of assets committed to short-term investments rose 5.5%. Money market funds, commercial paper, and other short-term commitments accounted for nearly 12% of equity fund assets among this year's participants.

Equity fund investment in U.S. Government securities and corporate bonds did not change substantially from last year's levels. Investment in longer term U.S. Government bonds increased only 1.81% in the latest survey, while the percentage of assets committed to corporate bonds remained about the same (1% in 1979, .27% in 1980).

Balanced Funds

The 1980 survey included data from 38 balanced funds, compared with 51 funds in last year's sample. Between the two samples of balanced funds themselves, there were significant differences in the distribution according to asset size. In 1979, 74.5% of the funds in this category claimed assets of "under 25 million"; in 1980, funds with assets in that range represented 82% of the total. The range of asset-size classifications extending from $25 million to $75 million held 15% of this year's responding funds, down from 17.8% last year. Larger funds — $75 million to above $100 million in assets — constituted only 3% of this year's sample compared with 7.7% in 1979.

The balanced funds in this year's survey offered, in a sense, the most anomalous results. While other funds indicated greater emphasis on short-term investments and a growing disenchantment with corporate bonds and some government securities, the balanced funds remained strong in these commitments. The percentage of assets invested in long-term corporate securities did decline slightly (21.14% in 1979, 19.67% in 1980), but there was a dramatic rise in the percentage committed to U.S. Government securities, from 8.9% last year to 20.35% in the most recent poll.

Investment in common stocks among the polled balanced funds dropped 6.2% from 1979 levels, while the percentage of assets committed to short-term investments remained essentially unchanged.

Tax-Exempt Funds

While interest in U.S. Government securities waxed among balanced funds, it waned among the tax-exempt funds polled. Last year, tax-exempt funds reported 18% of their assets in U.S. Governments; this year, that dropped to .55%.

Interestingly, municipals gained strength among tax-exempt funds in the latest survey, claiming 96.48% of total assets, an increase of 19.78% over the 1979 percentage.

Income Funds

Nowhere in the survey results was the shift away from long-term fixed-income investments to short-term commitments more dramatic than among income funds. The percentage of assets committed to short-term investments among the funds was almost triple that of last year, jumping from 12.8% to 36.01%. Similarly, cash and savings accounted for 7.94% of all assets this year, up from 1.3% in 1979.

All other types of investments lost ground among income funds. The percentage of total assets in long-term corporate securities fell 15.85%, while the holdings committed to U.S. Governments dropped 6.44%. Investment in common stock was also down 2.62% from last year's levels.

Industry Rankings

Across-the-board gains in the industry categories of "Electrical & Electronics," "Food & Beverage," and "Transportation" suggest a surge of interest in these areas among common trust fund investment managers. The proportional number of funds holding stocks in drug manufacturing firms and metal industry companies, on the other hand, declined substantially. Surprisingly, enthusiasm for "Oil Services & Equipment" seems to have ebbed among fund managers responding to this year's poll. "Multi-industry" firms fared well in the survey, however, recouping from last year's decline to regain their strong position of two years ago.

One aspect of the industry rankings suggests greater diversification of such investment among funds. In over a third of the categories listed, while traditional industry favorites maintained their top rankings, they held those positions by slimmer margins this year.

A new criterion was established this year for selecting stocks to be included in the industry rankings. This criterion eliminated not only some stocks from published categories, but also a few industry categories themselves. In the past

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even if only a few funds held a particular stock, that stock was listed in the industry rankings. Primarily for space considerations, this year's listing includes only the names of stocks held by 5% of the funds reporting. Consequently, numerous individual stocks and several categories which appeared last year — "Airlines," "Coal," "Glass," "Services," and "Tire & Rubber" — are not found in this year's industry rankings.

Included in the categories revealing significant changes were:

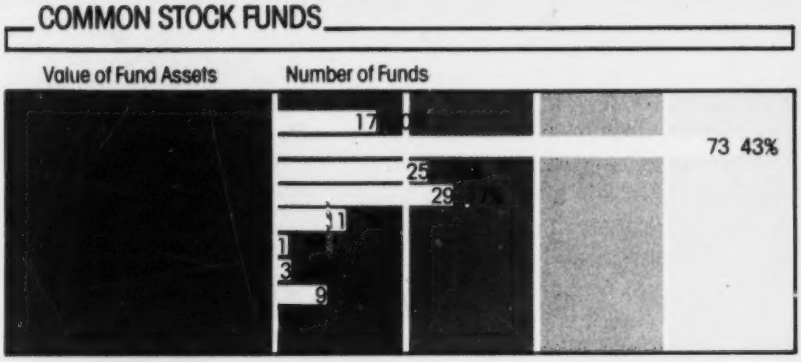
Banking & Finance — Citicorp retained its number-one ranking though its leading margin was smaller than in recent years. BankAmerica and J. P. Morgan maintained both their positions, though the percentage of surveyed funds holding their stock declined somewhat.

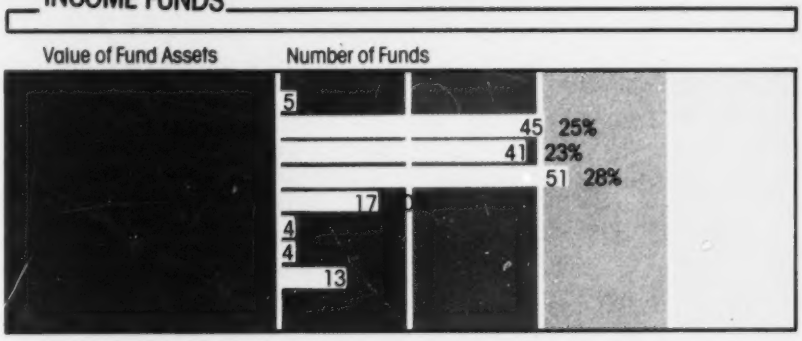
Chemicals — DuPont and Baxter Travenol managed to hold their own in a category which, overall, contained a smaller percentage of holding funds than last year's survey. Dow Chemical, the perennial favorite, was found in 53 fewer portfolios this year.

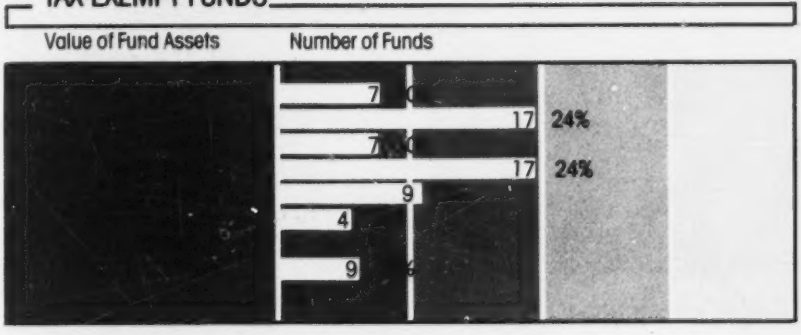
Drugs & Cosmetics — This category also revealed a drop in the total number of polled funds investing in drugs and cosmetics. Nevertheless, Warner Lambert, Johnson & Johnson, and Lilly & Co. gained ground. Gillette, while finishing last in the rankings, was found in twice as many portfolios this year as last.

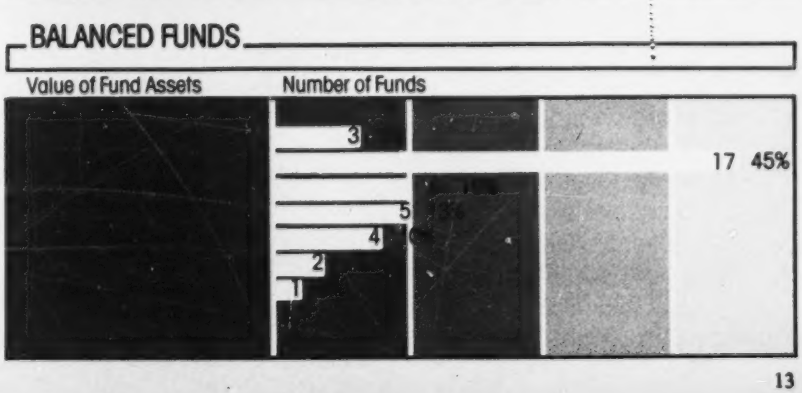
Electrical & Electronics — Raytheon registered a sixfold increase in the number of funds holding its stock, compared with 1979 survey results, lifting it to fourth place in the current rankings. A reduction in the number of polled funds holding Whirlpool, Texas Instruments, Hewlitt-Packard, Sperry Rand, Sunbeam, Maytag, and Reliance Electric removed these companies from the industry rankings in this year's survey.

Food & Beverage — Coca Cola edged out Beatrice Foods to take first place in the current survey. After two years in sixth place, McDonald's climbed to fourth po-









sition this year. In an industry where all stocks in the rankings registered gains, Heublein and CPC garnered the largest increases, picking up 19 and 18 funds respectively.

Forest Products — Georgia Pacific climbed from fourth to second place this year, substantially narrowing the lead of the repeating first-place finisher, Weyerhauser. Though a traditional favorite among fund managers responding to our annual poll, Weyerhauser was held by 37 fewer funds this year compared with 1979 data. International Paper, which held second place last year, also appeared in fewer portfolios this year and dropped to third position. Kimberly Clark returned to the rankings this year following a two year absence.

Insurance — Familiar names filled the top slots in this list again this year. Continental Insurance replaced Aetna as the current leader, while Aetna dropped to third place behind Marsh & McLennan. U.S. Fidelity & Guaranty slipped from third to fourth position.

Leisure — While retaining first place, American Express was held by 29 fewer reporting funds this year. CBS eclipsed Walt Disney Productions to capture second place in the rankings.

Machinery — This year marked the return of Deere & Co. to both the industry rankings, where it finished second, and the "Favorite Fifty." Black & Decker also joined the rankings in this category, which otherwise remained the same as last year. However, the number of funds holding Caterpillar Tractor, which again took first place, dropped by 43.

Metals — Over the past few years, the Annual Common Trust Fund Survey has noted a decline in interest among fund managers in metal industry stocks. This year was no exception. Currently, only one company — Aluminum Company of America — appeared in enough portfolios to merit recognition.

Multi-industry — This year's list mirrors the 1979 rankings. However, in the current sample, 3M was held by 20 more funds while IT&T gained 11.

Office Equipment — The only notable change in this category was Burrough's drop from second to third place in the past year.

Oil Service & Equipment — Again, the traditional industry leaders — Schlumberger and Halliburton — lost some of their usually substantial winning margins. Schlumberger was held by 31 fewer funds this year, Halliburton by 30 fewer. The number of funds holding fourth-ranked MAPCO, on the other hand, was more than double last year's total.

Petroleum — The top five stocks in this group varied little from those in 1979's list. Gulf Oil climbed from twelfth to eighth place; Conoco rose from ninth to sixth.

Retailers — After two years in second place, K-Mart beat traditional leader Sears to take top position in the current rankings. Central to that turnabout was the fact that Sears was held by 44 fewer funds this year. J. C. Penney remained third for the fourth consecutive year, despite a decline in the number of funds holdings its shares.

Transportation — The current survey data suggest a resurgence of interest in railroads among fund managers, with four rail stocks being held by more than 20 funds for the first time in years. Norfolk & Western Railway rejoined the listing while Southern Railway made an initial appearance. The only loss was suffered by last year's front-runner, Santa Fe Industries, which retired from the rankings this year.

Utilities-Electric — Interest in electric utilities remained stable, although some fluctuation occurred in the rankings. Southern California Edison dropped from second to fourth place, sharing that spot with climbing Florida Power & Light and newcomer Northern States Power. □

For industry rankings, common stock index, and graphic analysis of survey results, see pp. 20-29.

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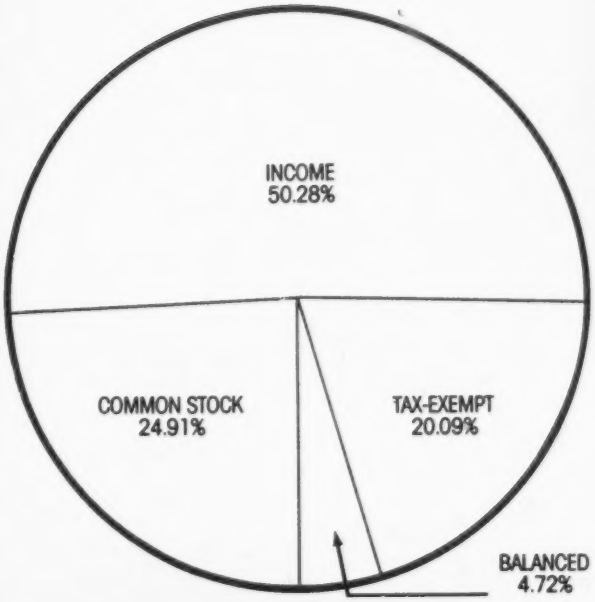
31st Common Trust Fund Survey

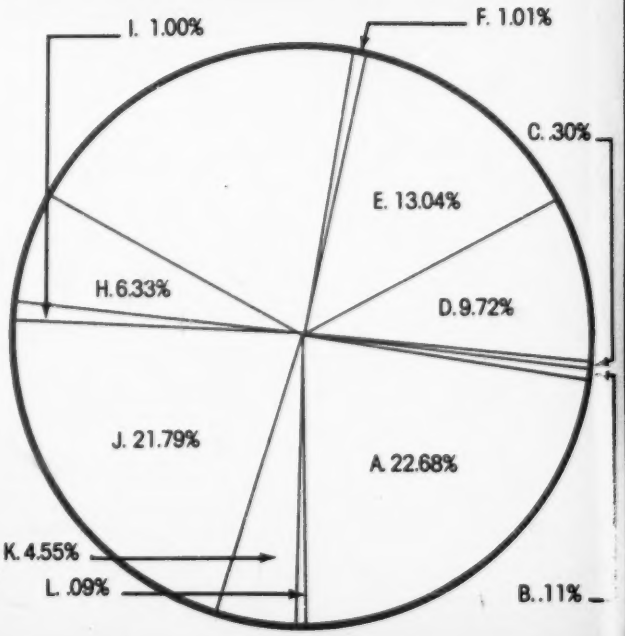
ANALYSIS OF COMMON TRUST FUNDS SURVEYED

The pie charts below illustrate the proportional size of each of the four major types of funds — common stock, balanced, tax-exempt, and income — included in our sample of 456 common trust funds, as well as the asset diversification of all the surveyed funds combined. The charts on the opposite page provide a more detailed breakdown of the assets held by each primary group of funds. Notably, this year's sample contained a significantly higher percentage of funds with holdings worth more than $100 million. This larger percentage of wealthy funds, as well as the undeniable effects of inflation, raised the value of the combined assets of all surveyed funds from $6.6 billion last year to $11.9 billion in 1980.

COMPOSITION OF FUND ASSETS

	(in millions)	%
	$ 2,693,330	22.68
	12,726	.11
	36,119	.30
	1,153,922	9.72
	1,547,867	13.04
	119,484	1.01
	2,301,418	19.38
	751,464	6.33
	119,240	1.00
	2,586,884	21.79
	539,775	4.55
	10,401	.09
	$11,872,589	100.00



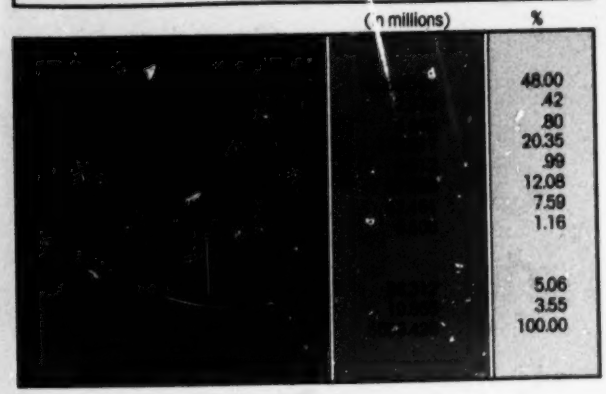


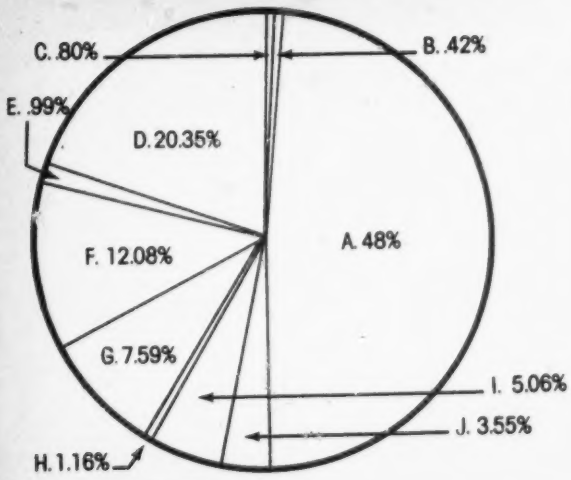
PROPORTION OF FUND GROUPS

	(in millions)	%
	$ 559,424	4.72
	2,385,471	20.09
	5,969,971	50.28
	2,957,719	24.91
	$11,872,589	100.00

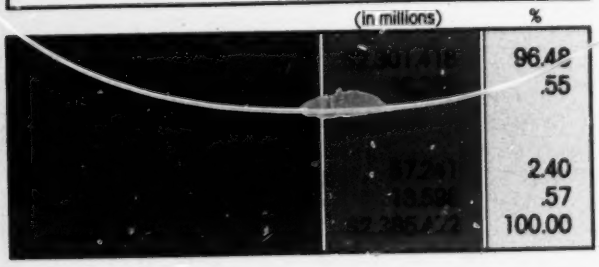
BEST AVAILABLE COPY

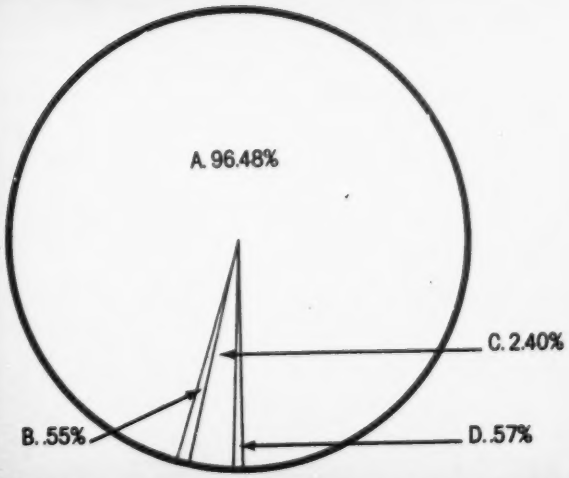
BALANCED FUNDS

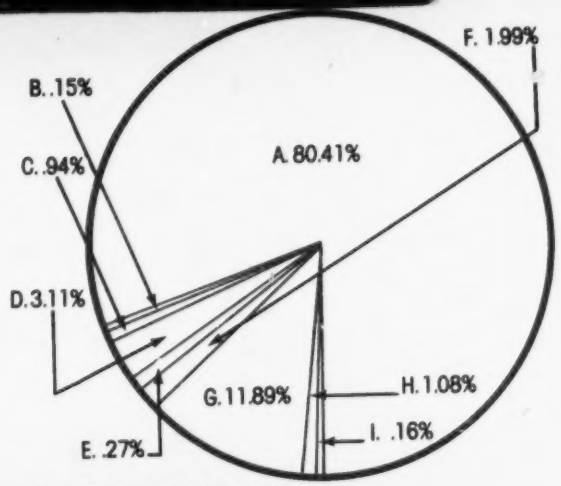




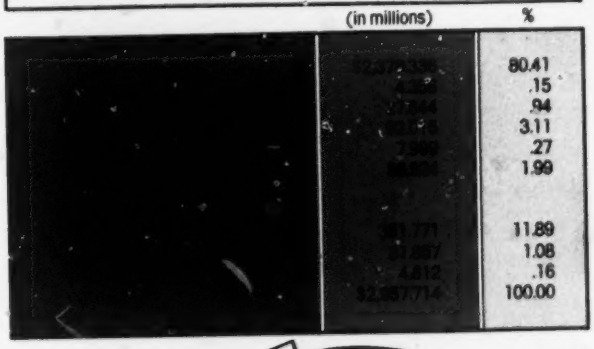
TAX-EXEMPT FUNDS

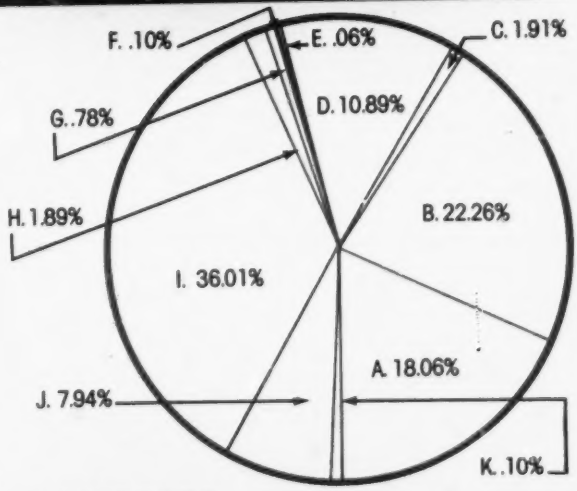




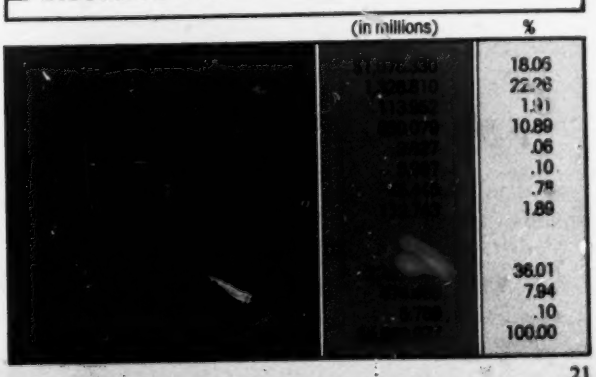


COMMON STOCK FUNDS





INCOME FUNDS



31st Common Trust Fund Survey

Common Stock Rankings by Industry

For this section of the 31st Annual Common Trust Fund Survey, a new criterion was used in evaluating stocks to be included in the industry rankings. Only stocks which were held by at least 5% of the surveyed funds holding common stock are listed here. This new criterion eliminated not only a number of companies which were included in last year's survey, but also several of the categories themselves. A list of all common stocks held by the responding funds begins on page 24.

INDUSTRY	NO. OF FUNDS
Aerospace	
United Technologies	27
TRW	26
Boeing	24
Auto	
General Motors	71
Ford Motor Co.	37
Banking & Finance	
Citicorp	63
BankAmerica	44
J. P. Morgan	33
Chemicals	
Dow Chemical	72
E. I. du Pont de Nemours	53
Union Carbide	37
Baxter Travenol	32
Schering Plough	26
American Cynamid	23
Monsanto	22
Stauffer Chemical	20
Containers	
Continental Group	24
Drugs & Cosmetics	
Merck	84
American Home Products	77
Procter & Gamble	60
Colgate Palmolive	54
Bristol Meyers	50
Warner Lambert	50
Johnson & Johnson	49
Pfizer	48
Avon Products	43
Abbott Laboratories	40
Eli Lilly & Co.	37
SmithKline	31
Revlon	30
American Hospital Supply	23
Gillette	21
Electrical & Electronics	
General Electric	154
Emerson Electric	64
RCA	33
Raytheon	31
Food & Beverage	
Coca Cola	66
Beatrice Foods	52
Pepsico	48
McDonald's	44
General Mills	39
Kraft	38
General Foods	35
Norton Simon	25
Heublein	23
CPC International	22
Borden	20
Forest Products	
Weyerhauser	39
Georgia Pacific	36
International Paper	32
Union Camp	25
Kimberly Clark	22
Insurance	
Continental Insurance Corp.	27
Marsh & McLennan	25
Aetna	23
U.S. Fidelity & Guaranty	21
Leisure	
American Express	44
CBS	24
Walt Disney Productions	20
Machinery	
Caterpillar Tractor	79
Deere & Co.	37
Ingersoll-Rand	28
United Technologies	27
Black & Decker Manufacturing	21

Metals	
Aluminum Co. of America	22
Multi-Industry	
Minnesota Mining & Manufacturing	99
International Tel. & Tel.	41
Office Equipment	
International Business Machines	219
Xerox	88
Burroughs	68
Digital Equipment	20
Oil Service & Equipment	
Schlumberger	62
Halliburton	43
Dresser Industries	32
MAPCO	22
Petroleum	
Exxon	170
Atlantic Richfield	105
Standard Oil of Indiana	95
Phillips Petroleum	75
Mobil Oil	72
Conoco	57
Texaco	54
Gulf Oil	34
Standard Oil of California	33
Tenneco	29
United Technologies	27
Union Oil of California	22
Photo Equipment	
Eastman Kodak	115
Retailers	
K-Mart	73
Sears, Roebuck, & Co.	62
J.C. Penney	44
Federated Department Stores	36
Tobacco	
Phillip Morris	76
R.J. Reynolds	66
Transportation	
Union Pacific	53
Southern Railway	24
Norfolk & Western Railway	20
Utilities-Electric	
Texas Utilities	40
Commonwealth Edison	31
Central & Southwest	30
Florida Power & Light	21
Northern States Power Co.	21
Southern California Edison	21
Utilities-Gas & Electric	
American Natural Resources	28
Utilities-Telephone	
American Tel. & Tel.	180
General Telephone & Electronics	51
United Telecommunications	24

31st Common Trust Fund Survey

All Common Stocks in Surveyed CTFs

Stock	Number of Funds
Abbot Labs	40
ABC	17
ACF Ind.	8
Acme Cleveland	1
Aetna	23
Affil. Bankshares of Colorado	1
Ahmanson, H. F.	4
Airborne Freight	1
Air Products & Chemicals	19
Akzona	1
Alabama Bancorporation	1
Alberto-Culver	1
Albertson's	6
Alcan Aluminum	11
Alexander & Alexander	4
Allegheny Power System	12
Allergan	2
Allied Chemical	12
Allied Stores	10
Allis Chalmers	9
Alpha Portland Ind.	2
Aluminum Co. of America	22
Amalgamated Sugar	1
Amax	9
Amdahl	1
Amerada Hess	11
American Air Filter	1
American Air Lines	3
American Appraisal Assoc.	2
American Brands	14
American Can	11
American Cynamid	23
American District Telegraph	4
American Electric Power	13
American Express	44
American Fletcher	1
American General Insurance	4
American Greetings	3
American Hoist & Derrick	3
American Home Products	77
American Hospital Supply	23
American International Group	6
American Medical International	3
American Motors	1
American Nat'l. Financial	1
American Natural Resources	28
American Petroflex	1
American Standard	7
American Sterilizer	2
American Stores	3
American Tel. & Tel.	180
Ametek	2
AMF	3
AMP	16
Ampex	1
AM International	3
Amstar	2
Amsted Ind.	6
Anchor Hocking	2
Anderson, Clayton	1
Anheuser Busch	17
ARA	15
Archer-Daniels-Midland	2
Arizona Bank	3
Arizona Public Service	7
Arkansas Louisana Gas	8
Armco	6
Armstrong Cork	11
Armstrong World Ind.	2
ASA	1
Asarco	1
Ashland Oil	3
Assoc. Dry Goods	10
Atlantic Bancorporation	1
Atlantic City Electric	3
Atlantic Richfield	105
Augat	1
Automatic Data Processing	9
Avco	1
Avery International	1
Avnet	5
Avon Products	43
Baker International	16
Baltimore Gas & Electric	12
Bancohio	2
Bandag	1
BankAmerica	44
Bankers Security Life Ins.	1
Bankers Trust N.Y.	5
Bank of Virginia	1
Bard, C. R.	3
Barnes Group	1
Bassett Furniture Ind.	1
Bausch & Lomb	1
Baxter Travenol	32
BBDO International	2
Bearings	2
Beatrice Foods	52
Beckman Instruments	4
Becton, Dickinson	9
Beech Aircraft	1
Beker Ind.	1
Belco Petroleum	2
Belden	1
Bell Tel. of Canada	1
Bemis	2
Bendix	18
Beneficial	13
Best Products	3
Bethlehem Steel	3
Betz Labs	9
Big Three Ind.	14
Black & Decker Mfg.	21
Blair, John	1
Block, H. & R.	3
Blue Bell	4
Boeing	24
Boise Cascade	4
Borden	20
Borg Warner	6
Brae	1
Braniff	2
Briggs & Stratton	8
Bristol Meyers	50
British Petroleum	1
Brockway Glass	1
Brooklyn Union Gas	1
Brown Co.	1
Brown Forman Distillers	2
Brown Group	1
Brown & Sharpe Mfg.	1
Browning Ferris Ind.	5
Brunswick	2
Bucyrus-Erie	11
Burlington Ind.	9
Burlington Northern	7
Burndy	5
Burroughs	68
Butler Mfg.	1
Cabot	1
Caldor	2
Campbell Red Lake Mines	3
Campbell Soup	7
Canadian Pacific	3
Capital Cities Communications	4
Capital Holding	17
Carnation	14
Carolina Power & Light	7
Carpenter Technology	4
Carrier	2
Carter, William	1
Carter, Hawley, Hale Stores	8
Castle & Cooke	1
Caterpillar Tractor	79
CBI	2
CBS	24
CBT	1
Celanese	3
Central & Southwest	30
Central Bancshares South	1
Central Illinois Light	3
Central Louisiana Energy	2
Central Maine Power	1
Central Tel. & Utilities	12

Centran....1
Cessna Aircraft....3
Champion International....14
Champion Spark Plug....6
Chase Manhattan....11
Chemed....1
Chemical New York....6
Chesebrough Pond's....17
Chessie System....3
Chicago Pneumatic Tool....2
Chrysler....1
Chubb....5
Church's Fried Chicken....3
Cincinnati Gas & Electric....6
Cincinnati Milacron....4
Circle K....1
CIT Financial....6
Citicorp....63
Cities Service....12
Citizens Fidelity....1
City Investing....1
Clark Equipment....18
Cleveland Cliff Iron....5
Cleveland Electric Illuminating....11
Clevetrust....2
Clorox....1
Cluett, Peabody....4
Coca Cola....66
Coleman....2
Colgate Palmolive....54
Collins & Aikman....3
Colonial Life & Accident....1
Colonial Penn....5
Colorado National Bancshares....3
Colt Ind.....5
Columbia Gas Systems....5
Columbia Pictures Ind.....2
Combined Communications....1
Combined Ins. Co. of America....13
Combustion Engineering....7
Comdisco....1
Commerce Clearing House....4
Commercial Shearing....1
Commonwealth Edison....31
Communications Ind....1
Communications Satellite....11
Community Public Service....1
Compugraphic....4
Computer Sciences....2
Con Agra....1
Cone Mills....1
Connecticut General Ins.....14
Conoco....57
Consolidated Edison of N.Y.....3
Consolidated Foods....9
Consolidated Freightways....10
Consolidated Natural Gas....5
Consolidated Papers....2
Consumers Power....5
Continental....27
Continental General Ins.....1
Continental Group....24
Continental Illinois....18
Continental Telephone....15
Control Data....5
Cooper Ind....12
Coors, Aldoph....2
Copeland....1
Copperweld....1
Corning Glass Works....13
Cox Broadcasting....1
CPC International....22
Crane....2
Crawford....1
Cray Research....1
Crocker National....3
Cross, A. T.....1
Cross & Trecker....1
Crouse-Hinds....4
Crown Cork & Seal....1
Crown Zellerback....8
Crum & Forster....2
Cummins Engine....5
Cunningham Drug Stores....1
Cutler Hammer....1
Cyclops....1
Cyprus Mines....1

Dana....6
Dart Ind.....6
Data General....1
Datapoint....4
Dayton Hudson....18
Deere....37
De Kalb AgResearch....2
Delmarva Power & Light....2
Del Monte....2
Delta Air Lines....14
Deluxe Check Printers....5
Dennison Mfg.....2
Denny's....4
Detroit Edison....2
Dexter....2
Dial....1
Diamond International....11
Diamond Shamrock....13
Diebold....1
Digital Equipment....20
Dillon....3
Disney, Walt Productions....20
Dome Mines....1
Dominion Bancshares....2
Donnelly, R. R. & Sons....5
Dover....5
Dow Chemical....72
Dow Jones....3
Dravco....1
Dresser Ind.....32
Dr. Pepper....2
Duke Power....15
Dun & Bradstreet....19
Du Pont, E. I. de Nemours....53
Duquesne Light....2

Eagle-Picher Ind.....3
Earth Resources....1
Eastman Gas & Fuel....6
Eastman Kodak....115
Eaton....14
Echlin Mfg.....11
Eckerd, Jack....10
Economics Laboratory....6
Edison Bros. Stores....3
EG&G....2
Electronic Data Systems....2
Electronics Corp. of America....1
El Paso....6
Emerson Electric....64
Emery Air Freight....12
Emhart....11
Energy Reserves Group....1
Englehard Minerals & Chemicals....7
ENSERCH....10
Entex....1
Envirotech....3
Equifax....3
Equitable....4
ERC Group....5
Esmark....4
Ethan Allen....1
Ethyl....3
Evans Products....4
Ex-Cell-O....4
Exxon....170

Faberge....1
Fairchild Camera & Inst.....3
Farmers Group....2
Federal Express....3
Federal Mogul....4
Federal National Mortgage....7
Federated Dept. Stores....36
Federated Paper Board....2
Fidelity Union Life....1
Firestone Tire & Rubber....12
First Atlanta....1
First Bank System....9
First Charter Financial....2
First Chicago....7
First City Bancorporation of Texas....6
First Hawaiian....2
First International Bankshares....18
First Maryland....2
First & Merchants....1
First Mississippi....1
First National....3
First National Boston....7
First Pennsylvania....1
First Security....3
First Tennessee National....1
Fischbach & Moore....3
Fleetwood Enterprises....1
Fleming....2
Flexi-Van....2
Flintkote....2
Florida National Banks of Florida....1
Florida Power & Light....21
Fluke, John Mfg.....1
Fluor....11
FMC....9
Food Fair....1
Ford Motor....37
Foremost McKesson....7
Forest Oil....1
Ft. Howard Paper....3
Foster Wheeler....3
Four Phase Systems....1
Foxboro....4
Fox-Stanley Photo....1
Franklin Life Ins.....1
Franklin Mint....1
Freeport Minerals....5
Fuller, H. B.....1

Gannett....14
Gardner-Denver....1
Garfinkle, Brooks Bros, Miller, & Rhodes....1
GATX....6
GCA....1
Geico....2
Gen. American Oil of Texas....1
Gen. Automotive Parts....1
Gen. Cinema....2
Gen. Dynamics....2
Gen. Electric....154
Gen. Foods....35
Gen. Mills....39
Gen. Motors....71
Gen. Portland....2
Gen. Public Utilities....5
Gen. Reinsurance....6
Gen. Signal....15
Gen. Tel. & Electronics....51
Genesco....1
Genuine Parts....19
Georgia Pacific....36
Geosource....1
Gerber Products....5
Getty Oil....11
Giddings & Lewis....3
Gillette....21
Gino's....1
Girard....2
G. K. Technologies....6
Glatfelter....1
Global Marine....1
Goodrich, B.F.....1
Goodyear Tire & Rubber....18

Stock	Number of Funds
Gordon Jewelry	1
Gorman & Rupp	1
Gould	6
Gould's Pumps	1
Grace, W. R.	3
Graco	1
Grainger, W. W.	15
Great Atlantic & Pacific Tea	1
Great Lakes Chemical	1
Great Northern Nekoosa	4
Great Western Financial	10
Greyhound	1
Gromman	1
Gulf Oil	34
Gulf States Utilities	3
Gulf United	6
Gulf & Western Ind.	1
Hall, Frank B.	2
Halliburton	43
Hamilton Bros. Petroleum	1
Hammermill Paper	3
Handleman	1
Hanes	1
Hanna Mining	6
Harcourt, Brace, Jovanovich	3
Harland, John H.	1
Harrah's	1
Harris	13
Hart, Schaffner, & Marx	1
Harte-Hanks Communications	2
Hawaii Bancorporation	3
Hawaiian Electric	1
Hazleton Laboratories	2
Heck's	1
Heinz, H. J.	14
Heller, Walter E. International	7
Helmerich & Payne	1
Hercules	14
Hershey Foods	1
Hershey Oil	1
Heublein	23
Hewlett-Packard	17
Hexcel	1
Hibernia	1
Hilton Hotels	6
Hobart	4
Holiday Inns	4
Holly Sugar	1
Home Beneficial	1
Homestake Mining	4
Honeywell	13
Hook Drugs	1
Hoover Universal	2
Hospital Corp. of America	14
Houghton Miflin	1
Household Finance	12
Houston Ind.	18
Houston Lighting & Power	1
Houston Natural Gas	14
Houston Oil & Minerals	2
Howard Johnson	1
Hubbell, Harvey	2
Hudson Bay Mining & Smelting	1
Hughes Tool	19
Humana	4
Hunt, Phillip Chemical	2
Hunt International Resources	1
Huyck	2
Hyster	1
I.C. Ind.	3
Idaho Power	8
Ideal Basic Ind.	1
Ideal Toy	1
Illinois Power	11
Illinois Tool Works	2
Imperial Oil	4
Imperial Corp. of America	2
I.N.A.	17
Inco	6
Independent Life & Accident Ins.	1
Indiana Financial Investors	1
Indiana Mortgage & Realty Investors	1
Indianapolis Power & Light	3
Indianapolis Water	1
Industrial National	1
Ingersoll Rand	28
Inland Steel	14
Inspiration Consolidated Copper	1
Instrumentation Laboratory	1
Intel	5
Interco	5
Interlake	4
International Business Machines	219
International Flavor & Fragrence	13
International Harvestor	6
International Minerals & Chemical	7
International Multifoods	1
International Paper	32
International Tel. & Tel.	41
Interpublic Group	2
Iowa Beef Processors	1
Iowa Electric Light & Power	1
Iowa & Illinois Gas & Electric	2
Iowa Southern Utilities	1
Irving Bank	1
James, Fred S.	1
Jefferson Pilot	16
Jewel	3
Johns-Manville	11
Johnson, Howard	2
Johnson Controls	2
Johnson & Johnson	49
Josten's	7
Joy Mfg.	13
Kaiser Aluminum & Chemical	3
Kaiser Steel	2
Kaiser Resources	1
Kaneb Service	3
Kansas City Southern Ind.	1
Kansas Gas & Electric	1
Kansas Power & Light	5
Kaufman & Broad	1
Kellogg	14
Kennametal	1
Kennecott Copper	2
Kentucky Utilities	1
Kerr Glass Mfg.	1
Kerr McGee	18
Kidde, Walter	2
Kimberly Clark	22
Kings Department Stores	2
K-Mart	73
Knight-Ridder Newspapers	8
Koehring	1
Kollmorgen	2
Koppers	8
Kraft	38
Kroehler Mfg.	1
Kroger	6
Lance	2
Lane	1
Lawter Chemicals	1
Lear Siegler	1
Leaseway Transportation	2
Lee Enterprises	1
Leggett-Pratt	1
Lenox	5
Levi Strauss	3
Libbey-Owens-Ford	1
Liberty National Life Ins.	9
Liggett Group	3
Lilly, Eli	37
Lincoln National	15
Litton Ind.	3
Loctite	3
Loews	1
Logan, Johnathan	1
Lone Star Ind.	5
Long Island Lighting	1
Longs Drug Stores	2
Loral	3
Louisiana Land & Exploration	9
Louisiana-Pacific	3
Louisville Gas & Electric	2
Lowenstein, M.	1
Lowe's	11
Lubrizol	9
Lucky Stores	12
Macke	1
MacMillan	1
MA/COM	3
Macy, R. H.	5
Madison Gas & Electric	2
Mallinckrodt	9
Manhattan Ind.	1
Manufacturers Hanover	18
MAPCO	22
Marathon Oil	18
Marion	1
Marley	4
Marriott	1
Marsh & McLennan	25
Marshall Field	3
Martin Marietta	13
Maryland Cup	3
Maryland National	1
Masco	14
Masonite	7
Massey-Ferguson	1
MassMutual Mortgage & Realty Investors	1
May Department Stores	14
Mayer, Oscar	2
Maytag	16
MCA	5
McCormick	3
McDermott, J. Ray	13
McDonald's	44
McDonnell Douglas	2
McGraw Edison	9
McGraw-Hill	12
McLean Trucking	3
Mead	8
Measurex	2
Medalist Ind.	1
Medtronic	4
Mellon National	5
Melville	11
Mercantile Stores	1
Merck	84
Meredith	1
Merrill Lynch	1
Mesa Petroleum	10
Mesa Royalty Trust	1
Mesabi Trust	1
Metro-Goldwyn-Mayer	4
Metromedia	4
Meyer, Fred	3
MGIC Investment	4
Middle South Utilities	18
Midland Ross	2
Miller-Wohl	3
Millipore	6
Milton Bradley	2
Mine Safety Appliances	1
Minnesota Mining & Mfg.	99
Minnesota Power & Light	2
Mission Ins.	1
Missouri Pacific	10
Mobil Oil	72
Modern Merchandising	3
Mohasco	2

Monarch Capital....3
Monarch Machine Tool....1
Monsanto....22
Montana Power....3
Moore....6
Morgan, J. P.....33
Morrison Knudsen....2
Morse Shoes....1
Morton-Norwich Products....4
Motorola....15
Mountain Fuel Supply....7
Mountain States Tel. & Tel....1
Multimedia....1
Munsingwear....1
Murphy, G. C.....1
Murphy Oil....1

Nabisco....11
Nalco Chemical....6
Nashua....1
National Can....1
National City....3
National Data....2
National Distillers & Chemical....8
National Fuel & Gas....1
National Gypsum....3
National Medical Care....2
National Medical Enterprises....2
National Semiconductor....3
National Service Ind.....1
National Standard....1
National Steel....7
Natomas....3
NCH....2
NCNB....4
NCR....18
Nevada Power....1
New England Electric System....5
New England Gas & Electric....1
New England Nuclear....6
Newmont Mining....3
New York State Electric & Gas....2
New York Times....1
Niagra Mohawk Power....1
Nicolet Instrument....1
Nielsen, A. C.....5
NL Ind.....12
NLT....16
Noble Affiliates....5
Nordstrom....2
Norfolk & Western Railway....20
Norlin....1
Norris Ind.....1
North American Coal....1
North Indiana Public Service....11
Northern Natural Gas....10
Northern States Power....21
Northern Telecom....10
Northern Trust....1
Northrop....2
Northwest Airlines....7
Northwest Bancorporation....8
Northwest Energy....3
Northwest Ind.....11
Northwestern National Life....3
Norton....6
Norton Simon....25
Noxell....2
Numac Oil & Gas....1

Oak Ind.....1
Occidental Petroleum....7
Ocean Drilling & Exploration....1
Ogden....1
Ogilvey & Mather International....2
Ohio Casualty....3
Ohio Edison....4
Oklahoma Natural Gas....1
Outboard Marine....2
Overhead Door....1
Overnite Transportation....2
Overseas Shipholding Group....1
Owens Corning Fiberglass....10
Owens Illinois....16

Pabst Brewing....2
Pacific Gas & Electric....11
Pacific Lighting....2
Pacific Lumber....2
Pacific Power & Light....3
Pall....2
Palm Beach....1
Pan American World Airways....1
Pangas....1
Panhandle Eastern Pipeline....15
Parker Drilling....2
Parker-Hamilton....3
Parker Pen....3
Parsons....1
Patrick Petroleum....1
Payless Cashways....6
Payless Drug Stores Northwest....1
Pay N Pak Stores....1
Pay N Save....2
Peabody International....8
Penney, J. C.....44
Pennsylvania Power & Light....11
Pennwalt....4
Pennzoil....7
People's Gas....8
PepsiCo....60
Perkin Elmer....9
Peterson, Howell, & Heather....3
Petrie Stores....6

Stock	Number of Funds
Petrolane	1
Petrolite	1
Pfizer	48
Phelps Dodge	9
PHH Group	3
Philadelphia Electric	2
Philadelphia National	2
Phillip Morris	76
Phillips Petroleum	75
Pillsbury	15
Pioneer	7
Pitney-Bowes	6
Pittsburg National	7
Pittston	14
Pittway	1
Polaroid	5
Ponderosa System	1
Pope & Talbot	1
Potlatch	5
Potomac Electric & Power	5
PPG Ind.	13
Premier Ind.	1
Prentice-Hall	7
Proctor & Gamble	60
Provident Life & Accident	2
Public Service Co. of Colorado	17
Public Service Co. of Indiana	16
Public Service Co. of New Mexico	6
Public Service Electric & Gas	9
Puget Sound Power & Light	1
Pullman	5
Purex Ind.	3
Purolater	1
Quaker Oats	14
Quaker State Oil Refining	1
Questor	1
Ralston Purina	19
Ramada Inns	2
Ranger Oil of Canada	1
Raychem	1
Raytheon	31
RCA	33
Reading & Bates	3
Reeves Bros.	1
Reliance Electric	7
Republic Steel	7
Republic of Texas	6
Revco Drug Stores	15
Revere Copper & Brass	1
Revlon	30
Rexnord	4
Reynolds, R. J. Ind.	66
Reynolds Metals	4
Reynolds & Reynolds	2
Richardson-Merrell	5
Richmond, Fredericksburg, & Potomac Railway	1
Riggs National Bank	1
Rio Grande Ind.	1
Rite-Aid	3
Roadway Express	13
Robertshaw Controls	1
Rochester Gas & Electric	1
Rochester Telephone	1
Rockower Bros.	2
Rockwell International	6
Rohm	1
Rohm & Haas	3
Rollins	5
Rolm	2
Roper	1
Rorer Group	1
Rowan	2
Royal Crown	2
Royal Dutch Petroleum	7
Rubbermaid	4
Ryan Homes	4
Ryder Systems	5
Sabine	2
Safeco	3
Safeway Stores	12
St. Joe Minerals	7
St. Louis-San Francisco Railway	1
St. Paul	9
St. Regis Paper	6
Santa Fe Ind.	19
Santa Fe International	2
Savannah Electric & Power	1
Schering Plough	26
Schlumberger	62
Scientific-Atlanta	3
Scott & Fetzer	5
Scott, Foresman	2
Scott Paper	9
Scovill Mfg.	6
Sea Containers	3
Seaboard Coast Line Ind.	3
Seafirst	5
Seagram	3
Sealed Power	2
Searle, G. D.	4
Sears, Roebuck	62
Second National Bank of Warren	1
Security Pacific	19
Sedco	7
ServiceMaster Ind.	1
Service Merchandise	3
Shared Medical Systems	1
Shaw Ind.	1
Shell Oil	10
Sherwin Williams	1
Show Boat	1
Signal Companies	5
Signode	3
Simmons	1
Simplicity Pattern	1
Singer	3
Skaggs	1
Skyline	2
Smith International	9
SmithKline	31
Smith's Transfer	1
Snap-On Tools	9
Sonoco Products	2
Sony	1
South Carolina Electric & Gas	6
South Carolina National	1
South Jersey Ind.	1
Southeast Banking	1
Southern California Edison	21
Southern Company	13
Southern Indiana Gas & Electric	3
Southern Natural Resources	18
Southern Pacific	10
Southern Railway	24
Southern Union	2
Southland Corp.	10
Southland Royalty	1
Southwest Gas	1
Southwestern Life	3
Southwestern Public Service	4
Sperry Rand	13
Springs Mills	1
Square D	13
Squibb	19
Staley, A. E. Mfg.	1
Standard Brands	18
Standard Oil of California	33
Standard Oil of Indiana	95
Standard Oil of Ohio	8
Standard Register	1
Stanley Works	5
Stauffer Chemical	20

Stepan Chemical....2
Sterling Drug....17
Stevens, J. P.....4
Stewart & Stevenson Services....1
Stewart Warner....1
Stokely-Van Camp....1
Storage Technology....2
Stover, Russell Candies....1
Stride Rite....4
Studebaker-Worthington....2
Suburban Propane Gas....2
Sun Banks of Florida....1
Sun Co.....13
Sun Electric....4
Sunbeam....6
Sundstrand....6
Super Valu Stores....6
Superior Oil....4
Sybron....1
Syntex....8

Taft Broadcasting....1
Tampa Electric....5
Tampax....6
Tandy....3
Tecumseh Products....1
Tektronix....15
Teledyne....1
Tenneco....29
Teradyne....1
Texaco....54
Texas Commerce Bancshares....9
Texas Eastern Gulf....16
Texas Gas Transmission....8
Texasgulf....3
Texas Ind.....1
Texas Instruments....15
Texas Oil & Gas....11
Texas Utilities....40
Textron....9
Thiokol....1
Thompson, J. Walter....1
Thomas & Betts....6
Tidewater....2
Tiger International....4
Time....16
Times Mirror....6
Timken....5
Tokheim....1
Toledo Edison....1
Tonka....1
Toro....2
Trane....5
Transamerica....10
Transco....3
Trans Union....2
Transway International....5
Travelers....15
Triangle Pacific....1
TRW....26
Tucson Electric Power....11
Twentieth Century Fox Film....1
Tyco Labs....1
Tyler....4
Tymshare....2

UAL....8
UGI....1
UMC Ind....2
UNC Resources....1
Unilever....3
Union Camp....25
Union Carbide....37
Union Oil of California....22
Union Pacific....53
Uniroyal....1
United Banks of Colorado....3
United Energy Resources....1
United States Bancorporation....1
United States Fidelity & Guaranty....21
United States Gypsum....6
United States Home....1
United States Life....1
United States Shoe....1
United States Steel....11
United States Tobacco....7
United States Truck Lines....2
United Technologies....27
United Telecommunications....24
United Virginia Bankshares....1
Universal Foods....2
Universal Leaf Tobacco....1
Upjohn....15
USLIFE....1
Utah Power & Light....4

Valley National Bank....3
Varian Associates....1
V.F.....5
Virginia Electric & Power....16
Virginia National Bankshares....4
Viscom International....1

Wachovia....7
Walgreen....1
Walker, H., Gooderham, & Worts....1
Wallace-Murray....1
Wal-Mart Stores....4
Walter, Jim....4
Wang Laboratories....3
Warnaco....1
Warner Communications....11
Warner Lambert....50
Warner & Swassey....2
Washington National....1
Waste Management....8
Waters Associates....3
Watkins-Johnson....1
Wells Fargo....11
West Point Pepperell....6
Western Air Lines....2
Western Bancorporation....10
Western Co. of North America....1
Westinghouse Electric....16
Westmoreland Coal....3
Westvaco....2
Weyerhauser....39
Wheelabrator-Frye....7
Wheeling-Pittsburgh Steel....1
Whirlpool....16
White Consolidated Ind.....1
White Motor....1
Wickes....2
Willamette Ind....4
Williams....9
Wilshire Oil of Texas....1
Winn Dixie Stores....11
Wisconsin Electric Power....13
Wisconsin Gas....2
Wisconsin Power & Light....2
Wisconsin Public Service....2
Wiser Oil....1
Witco Chemical....3
Wolverine World-Wide....1
Woolworth, F. W.....2
Wrigley, William Jr.....3
WUI....1
Wyman-Gordon....1
Wyoming Bancorporation....1

Xerox....88

Yellow Freight System....9

Zayre....1
Zenith Radio....2
Zions Utah Bancorporation....1

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NOTE

ONLY THE FOLLOWING PAGES OF THIS PUBLICATION

HAVE BEEN FILMED

Cover 1, p. 2,

46-50.

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ESTATE PLANNING & ADMINISTRATION

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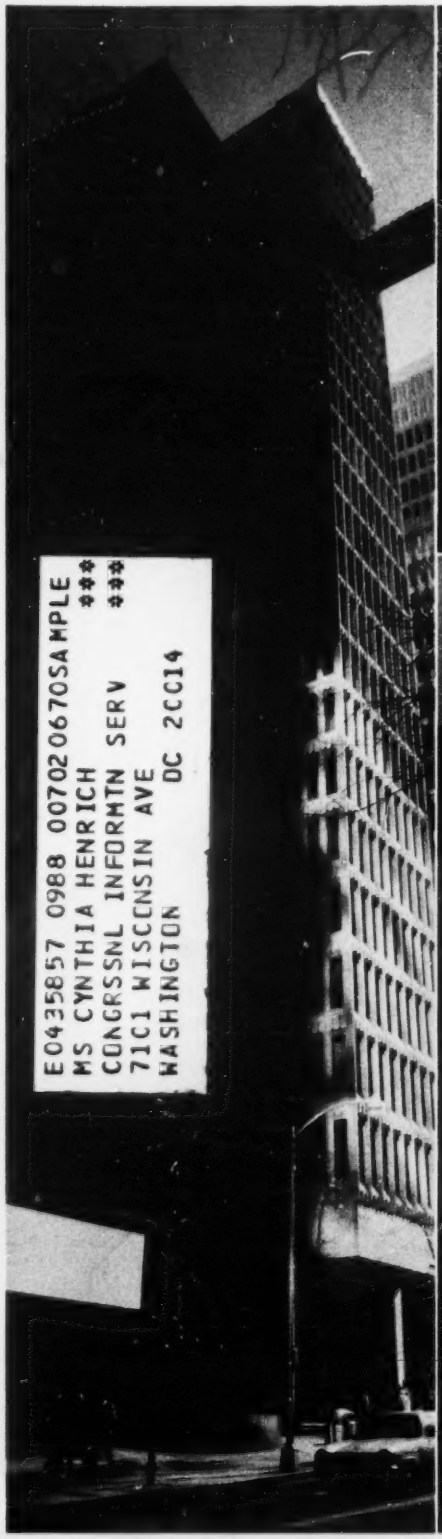

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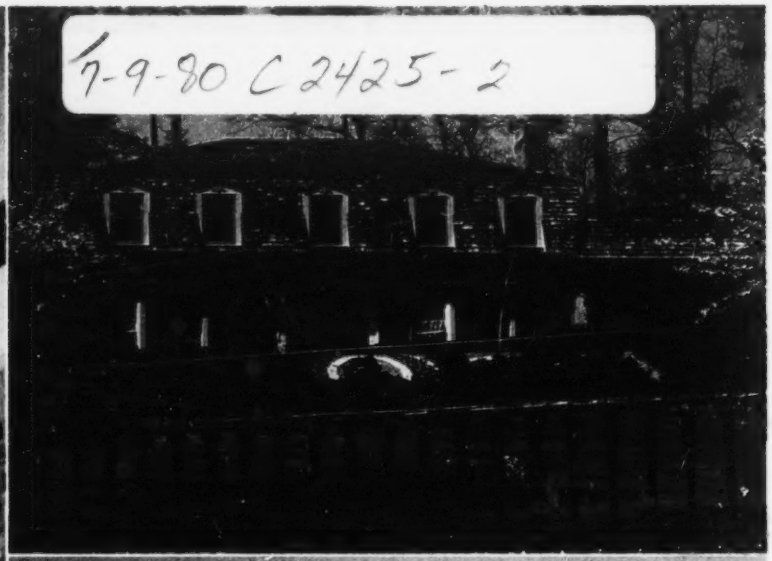

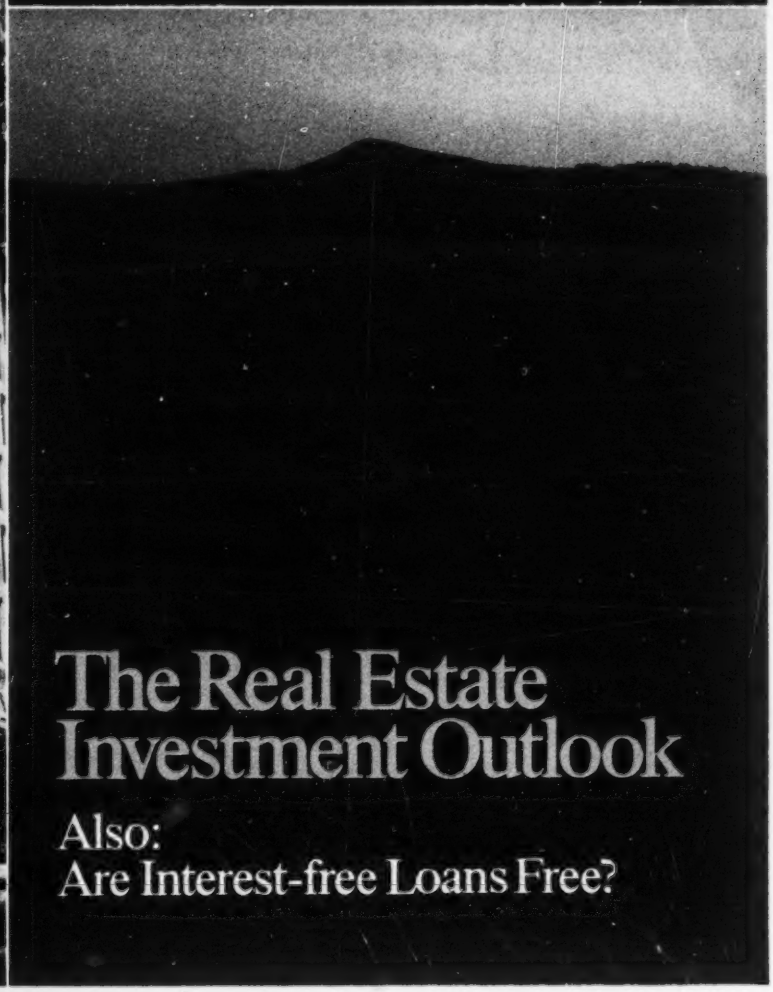

The Real Estate Investment Outlook

Also:
Are Interest-free Loans Free?

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TRUSTS & ESTATES

Volume 119, No. 7 JULY 1980

Estate Planning and Administration Since 1904

8 **Are Interest-free Loans Free?**
Recent rulings are encouraging *William R. Nicholas*

18 **How Does Real Estate as an Investment Compare with Stocks and Bonds?**
Quite well, as long as you know the risks *Thomas F. Cullen and Brian Blake*

23 **The Trust Department's Role in Real Estate Investment**
How one large Midwestern bank handles real estate *Terry W. Thompson*

25 **Property Tax Reform: Implications for Trust Departments**
Lessons of Proposition 13 *Peter Dinkelspiel*

28 **Planning for Emotionally Disabled Beneficiaries**
Recent legislation has raised new questions *Jeffrey L. Crown*

32 **Cattle as Alternative Investment: No Stampede by Estate Planners**
Why don't investors who own cattle like to discuss it? *Mark E. Battersby*

35 **Segmenting the Trust Market by Design, Not Default**
Some profitable segments have been overlooked *George M. Dupuy*

39 **Recent Developments in Structuring Delayed Like-Kind Exchanges**
IRS has restored an element of uncertainty *Gerald E. Whittenburg and Maureen L. Motsinger*

42 **The Plain English Will Revisited**
A suggested form with commentary *Lawrence X. Cusack*

46 **Treating the Body Economic: Thoughts on Interest Rates, Price Inflation, and Security Values**
The time has come to take our medicine *Jules Backman*

52 **Does Your Trust Department Need a Financial Counselor?**
An Interview with Houston's E. Deane Kanaly

59 **Philanthropy and Estate Planning**
Collapsed Tax Shelter — Gift of Gems *Conrad Teitell*

COVER

Pictured on this month's cover are types of real estate with which trust departments may find themselves involved, either as an investment or as part of estate administration. Commercial property is exemplified by Atlanta's Peachtree Center. Our examples of agricultural and residential property were photographed by Bill Coker.

REGULAR FEATURES

4 Editorial
6 Letters to the Editor
60 Institutional Investor
62 Law and Life Insurance
64 Fiduciary Decisions
67 Wills of the Month
69 Personnel Changes
72 Meetings & Conventions

Treating the Body Economic:

Thoughts on Interest Rates, Price Inflation, and Security Values

The cure is long and painful, but, according to the author, the time has come to take our medicine

by **JULES BACKMAN**
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New York University
New York, N.Y.

Interest rates have risen to record levels as a result of virulent price inflation. These higher interest rates have had a major impact on security values and upon some areas of the economy. To help bring inflation under control, the Federal Reserve Board has moved vigorously to control the supply of money.

Can the Fed control inflation by monetary policy alone? Will increased productivity provide the solution? To what extent is the price inflation caused by higher energy prices? How will high interest rates affect financial markets?

Federal Reserve Policy

The change in Federal Reserve monetary policy announced October 6, 1979, represented a watershed development, namely the shift in emphasis from stabilizing interest rates to control of bank reserves.

Under its former policy, the Fed continued to provide the reserves required to meet its interest rate targets. During a period of rising inflation and inflationary expectations, higher interest rates did not provide a deterrent to borrowing by business and consumers as the record amply demonstrates. By controlling increases in reserves, there is a limit to the volume of credit available, and this forces interest rates higher — at least in the short term.

This policy has had an immediate significant impact on housing and to some extent on consumer borrowing. Marginal projects for new business investment have been shelved. Less money is available to finance the takeover of companies and for speculation in stocks and in commodities.

On March 14, 1980, the Federal Reserve, as part of President Carter's anti-inflation program announced a number of new credit restrictions. These included the requirement that large commercial banks borrowing from the Fed are to pay a surcharge of 3 percentage points above the current 13% discount rate, for a total of 16%. (This was eliminated in May.) In addition, institutions granting credit were required to freeze 15% of new credit extended into a Federal Reserve account. A similar provision is applicable to money market funds. This was reduced to 7.5% in May. Banks voluntarily are to increase new lending by no more than 9% and hopefully less as well as to discourage unsecured consumer loans and others. Further, marginal reserve requirements on managed liabilities (such as large CDs) were

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raised from 8% to 10% and then cut to 5% in May and the base on which such reserve requirements were imposed will be reduced by at least 7%.

But all of these measures will not eliminate price inflation, which probably can be expected to continue at an inordinately high level. Other factors contributing to the high inflation rate include the large federal budgetary deficit, the large rise in unit labor costs, and to some extent the continuing rise in oil prices. There is no indication yet that these pressures are abating. However, the March 14 statement of President Carter pledged a balanced budget for fiscal 1981. Congress subsequently agreed upon a 1980-81 budget, which was precariously in balance.

Table I

Percent Changes in Consumer Price Index and Unit Labor Costs, 1950-1979

	Percent Change in CPI	Percent Change in ULC in Nonfarm Business Sector
1950-55	2.15%	3.10%
1955-60	2.03	3.00
1960-65	1.28	0.03
1965-70	4.24	4.84
1971	4.30	3.56
1972	3.30	2.78
1973	6.23	5.97
1974	10.97	12.61
1975	9.14	7.87
1976	5.77	4.70
1977	6.45	6.32
1978	7.66	8.11
1979	11.26	10.23

Role of Productivity

A myth widely propagated is that increased productivity can contribute significantly to a solution of the inflation problem. Productivity or output per manhour (OPM) affects price inflation by its relationship to change in total labor compensation (wages plus social security taxes plus other fringes). When labor compensation grows more rapidly than OPM, there is pressure for higher prices.

Throughout the late 1960s and 1970s, unit labor costs have risen every year in the nonfarm private business sector of the economy. And the increases have been similar for the Consumer Price Index. (See Table I above.)

Against this background, several facts must be emphasized. The long-term rate of increase in OPM has averaged about 2.4% annually. Since 1974, OPM has increased an average of about 1% annually. In the past year, it declined by about 1%. The emphasis upon increased productivity is based on the hope that we can return to the long-term level of 2.4%.

It may be seriously questioned whether such a goal can be readily achieved in the near future. With a sluggish or recessionary economy, there is little probability that OPM will rise significantly in 1980 since the trend of business volume plays a significant role in short-term trends of OPM.

But assume that OPM does increase to about 2%. What is the probability that increases in annual labor compensation will be reduced from the current rate of 9% to that level? The answer is zero. A major factor in labor negotiations is the rise in living costs during the existing contract. This means that double-digit inflation in 1979 will be the most important single factor determining increases in labor compensation in 1980.

With little change in OPM and continuing large increases in labor compensation, there will be little or no diminution of pressure on prices from higher unit labor costs in 1980. And the 1980 price experience will set the stage for a repeat performance in 1981.

Clearly, increases in OPM, while desirable to raise the level of living, can play only a minor and unimportant role in reducing the rate of price inflation.

In the past, the Fed has underwritten the large increases in labor costs by its expansionary monetary policy. This support has been modified by its new policy. However, the required cutback in the size of labor cost increases will take a number of years to achieve because of the catchup to past increases in consumer prices.

Role of Energy Prices

Despite the widespread belief to the contrary, except in 1974 and 1979, energy prices have contributed only to a small extent to the ongoing price inflation in recent years. In 1978, energy prices (6.3%) actually rose less than all other consumer prices (7.8%). For the year 1979, energy prices advanced 25.2% in contrast to the increase of 10.0% for all other prices; the result was a hike of 11.3% in the CPI. Thus, we reached the double digit level of inflation without energy prices.

These data probably understate the influence of higher energy prices to some extent because they do not allow for the impact of higher energy costs on the prices of other products (e.g. chemicals) or the impact of a declining foreign exchange rate on the higher prices for imports.

Nevertheless, it is clear that even if energy prices were stabilized, it would eliminate only a small part of the underlying price inflation.

Higher Interest Rates and Inflation

Some critics have complained that higher interest rates contribute significantly to price inflation. This mixes up cause and effect. To the extent interest rates are a cost to business, they add to the pressures for higher prices. However, this is a minor factor for most companies.

Price inflation causes higher interest rates and not the reverse. Lenders be-

Table II

Changes in Consumer Price Index and Yields on Triple A Bonds

	% Increase CPI	Yields on AAA Bonds	Spread
1950-55	2.15%	3.00%	0.85%
1955-60	2.03	3.97	1.94
1960-65	1.28	4.37	3.09
1965-70	4.24	6.38	2.14
1970-73	4.60	7.35	2.75

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come increasingly reluctant to make loans and to be paid back in dollars of lower purchasing power.

Historically, the real rate of interest — that is, the excess of interest yield over the inflation rate — has averaged between 2% and 3%. This has been the experience for AAA bond yields, as Table II on page 47 shows:

When the inflation rate accelerated in 1974 and 1975, the real yield on AAA bonds became negative. In the 1976 and 1977 period, real yields once more became positive. However, in some months in 1978 and since February 1979, the monthly and three-month average inflation rate began to exceed the yields on AAA bonds with the *negative* real interest rate between 3% and 4%. (See Table III below.)

In the first three months of 1980, despite the sharp rise in yields on AAA bonds to an average of 12.14%, they were still lower than the inflation rate. In the first quarter of 1980, the CPI was 18.1% higher than a year earlier, and about 17% higher than in the preceding three months.

Investors have become increasingly concerned about price inflation and the erosion of the real values of their principal. If the rate of price inflation should decline to 9%, on the basis of past experience AAA bonds should sell to yield 11-12%.

Interest Rates and the Investor

A popular myth is that an interest rate equal to the inflation rate protects the bondholder against inflation. This may be true for one year, as can be easily illustrated. Assume an investment of $200,000 at 10%, a 10% inflation rate, and a level of living of $20,000 (including income taxes). The investor will earn $20,000 the first year and have living costs of $20,000. His living costs rise to $22,000 in the second year, to $24,200 in the third year, to $26,620 in the fourth year, and to $29,282 in the fifth year. Meanwhile, income is fixed at $20,000. Clearly, this family is in deep trouble.

Even if the investment income is not required for living and can be added to principal, there is no full protection. Income taxes will take a big bite from the interest earned. With a 50% tax (State and Federal), the total principal increases to only $210,000 or only by 5% after one year. However, its real value or purchasing power has been reduced to $190,909 ($210,000 ÷ 110%). In the second year, interest earned is $21,000, and $10,500 is added to principal for a total of $220,500. However, its real value is reduced to $182,231. Under these conditions, the purchasing power of the principal will be reduced by almost 5% a year. For those in higher tax brackets, the loss is greater, and for those in lower brackets, it is smaller.

When the inflation rate exceeds bond yields, the trends described are aggravated. In fact, even if bond yields exceed the inflation rate by 2% or 3%, there is a loss of real purchasing power after taxes at these levels of inflation. This is true both for those who must live on their investment income and those who do not.

Moreover, when interest rates rise to higher levels, the market value of debt securities and interest sensitive stocks,

Table III

Changes in Consumer Price Index and the Level of Triple A Bond Yields, 1978-80

	Consumer Price Index			
	Year-to-Year Change	Month-to-Month Change	Change in Preceding 3 months	Triple A Bonds
		[annual rate]		
Jan. 1978	6.79%	7.08%	5.84%	8.41%
Feb. 1978	6.38	7.68	6.48	8.47
Mar. 1978	6.51	8.88	7.96	8.47
Apr. 1978	6.63	10.80	9.20	8.56
May 1978	7.03	11.28	10.40	8.69
June 1978	7.43	12.36	11.60	8.76
July 1978	7.72	8.64	10.88	8.88
Aug. 1978	7.91	6.72	9.32	8.69
Sept 1976	8.32	9.12	8.20	8.69
Oct. 1978	8.89	9.60	8.56	8.89
Nov. 1978	8.95	6.60	8.48	9.03
Dec. 1978	9.03	5.40	7.24	9.16
Jan. 1979	9.35	10.68	7.56	9.25
Feb. 1979	9.93	14.04	10.08	9.26
Mar. 1979	10.17	11.64	12.24	9.37
Apr. 1979	10.44	13.80	13.28	9.38
May 1979	10.76	14.76	13.52	9.50
June 1979	10.91	14.04	14.36	9.29
July 1979	11.29	12.72	14.00	9.20
Aug. 1979	11.78	12.12	13.08	9.23
Sept 1979	12.09	12.48	12.56	9.44
Oct. 1979	12.20	10.80	11.88	10.13
Nov. 1979	12.62	11.16	11.56	10.76
Dec. 1979	13.31	12.60	11.64	10.74
Jan. 1980	13.92	17.28	13.84	11.09
Feb. 1980	14.15	16.44	15.64	12.38
Mar. 1980	14.68	17.28	17.24	12.96
Apr. 1980	14.66	13.56	15.96	12.04

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such as public utilities, may decline significantly. For example, AT&T 8.80s of 2005 fell from 97 in November 1978 to 94½ in May 1979, 83 in November 1979 and 70 in March 1980; they increased to 85 early in June. This development aggravates the problem for those who must sell capital assets to maintain their level of living.

The Stock Market

Higher interest rates generally are considered bearish for stocks for several reasons:

1. They result in attractive alternatives to investments in stocks as was shown by the high yields on short-term and long-term debt in the early part of 1980.

As an aside, the six-month savings certificates do not provide a very attractive alternative today. The rate paid on these savings certificates is the discount for six month T-bills in the previous week's auction. However, this discount is not the yield on the investment. Report of the T-bill auction shows two figures: (1) the discount and (2) the bond yield basis. In the March 17, 1980, auction, for example, the discount used by the banks was 14.950%, but the bond yield equivalent was 16.40% or 145 basis points higher. In the June 2 auctions, the discount was 8.17%, and the bond yield equivalent was 8.64% or 47 basis points higher.

Moreover, local income taxes also must be given consideration. For example, the interest on the savings certificate is subject to New York State and New York City taxes while the interest on T-bills is not. Assuming a 40% federal tax bracket, the net cost of the State tax in March 1980 was 8.4% or 125 basis points. Thus, the net after state and local tax yield on T-bills bought at that time was 16.4% as compared with 13.70% for the savings account, a difference of 270 basis points. This figure would be reduced by the cost of buying the T-bill if it is not bought directly from the U.S. Treasury. On June 2, 1980, the yield on T-bills was 8.64% compared with 7.48% after state taxes on the savings certificate, a difference of 116 basis points.

There is another factor against the savings certificates. You are locked in for six months, or you forfeit part of the interest. In contrast, the T-bill can be sold at any time without losing interest. However, the amount received will depend upon the trend of interest rates and selling costs.

2. Higher interest rates result in a lower market value for a given level of dividends, as the sharp decline in public utility stocks has demonstrated. This development also makes long-term bonds less attractive as an alternative to stocks. The decrease in value can be very large as was noted earlier.

3. High interest rates also make margin trading very unattractive. Brokers' loan rate of 20% in March 1980 exceeded by a wide margin the long-term gains experienced by stocks. Various studies have shown that, over the very long term, common stocks have yielded an average of about 9% from dividends and capital gains. True, in shorter periods the gains have been much larger, if you can catch the cyclical swing, e.g., 1978 to 1979. However, it is sobering to realize that to cover today's interest cost on margin accounts, the gain on stocks must be about double the long-term rate *to break even.*

Against this background, it is not surprising that the most important single factor determining the large advance in stocks from March 1980 lows was declining interest rates. For long-term interest rates to decline significantly, the basic requirement is a significant abatement of price inflation.

Low PE Ratios

Each day the stock tables show the price-earnings (PE) ratios of companies traded on the New York Stock Exchange and the Amex. Similarly, the PE ratio of the Dow Jones average is reported weekly. In June 1980 that ratio was about 6-7 times. These reported ratios are at relatively low levels. Does this mean that stock prices are cheap? I don't know.

However, I do know that, because of the ongoing price inflation, the reported PE ratios are meaningless for most companies. Why? Because they do not reflect the large overstatement of reported net profits after taxes resulting from inflation. For companies which do not report inventories on a LIFO basis, part of the alleged profits must be used to replace inventories at higher prices than charged to costs. Similarly, in determining costs, depreciation is charged off on the basis of original cost so that part of the reported net profit must be used to finance higher cost replacements.

How large is the overstatement of reported net profits after taxes? Overall data are available for non-financial business. In 1979, the totals were as follows:

	Billions
Net profits after tax	$115.5
Inventory valuation adjustment	−41.9
Capital consumption adjustment	−15.6
Net profits after inflation adjustment	58.0
Dividends	47.2
Undistributed profits, adjusted	10.8

Net profits after adjustment for replacement costs of inventories and plant and equipment were only 50% of the reported total.

In 1979, the Dow Jones average PE ratio based on reported profits averaged about 6 times. If the adjusted earnings were used for the calculation, it would have been about 12 times.

The approximate data for inflation adjusted earnings for major companies are now reported in their annual reports in accordance with Statement of Financial Accounting Standards No. 33. The extent to which reported 1979 earnings would be adjusted downward may be illustrated for IBM and General Electric. (See Table IV at top of page.)

Obviously, these numbers do not tell the entire story because inflation also has increased the value of a company's property and hence the net worth of

Table 1[1]

Inflation-adjusted Earnings, 1979

	IBM	General Electric
Reported Earnings Per Share	$ 5.16	$ 6.20
Earnings Adjusted for General Inflation	3.85	4.66
Stock Price — March 19, 1980	59.00	47.00
PE Ratio — as Reported	11.4X	7.6X
PE Ratio on Adjusted Earnings	15.3X	10.0X

Sources: *Annual Reports 1979*, IBM, p. 34 and General Electric, p. 29.

most companies. Nevertheless, they do indicate the importance of looking behind the reported numbers in making investment decisions.

Conclusions

Price inflation is the most significant factor affecting the economy and financial markets. The distortions created affect business planning, economic activity, and economic values. Traditional measuring sticks lose their significance and the financial ship flounders on uncharted seas.

Inflation is a drug which infects all parts of the body economic. Withdrawal from any drug addiction inevitably is painful. Similarly, there is no easy way to end price inflation, but the price of withdrawal must be paid. The longer we wait, the greater the pain.

The elimination of price inflation will unavoidably adversely affect economic activity and be accompanied by greater unemployment. But the real choice is some unemployment now or much greater unemployment later as the inflation seriously impairs the effective functioning of the economy. When you go out on a binge, you can't avoid the morning after. Neither can the economy. □

Dr. Jules Backman, nationally known economist, author and educator, is research professor emeritus of economics at New York University's Schools of Business where he has been a member of the faculty since 1938. He is an authority on prices, labor problems, industry economics, and antitrust problems.

Dr. Backman has written more than 100 books and pamphlets and has contributed many articles to economic periodicals and trade journals, including TRUSTS & ESTATES. Among his writings are "Wage Determination," "The Economics of the Electrical Machinery Industry," "The Economics of the Chemical Industry," "Advertising and Competition," and "Inflation and the Price Indexes." He was formerly an editorial writer for *The New York Times.*

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Cover 1, p. 2,

15-18, 20-21.

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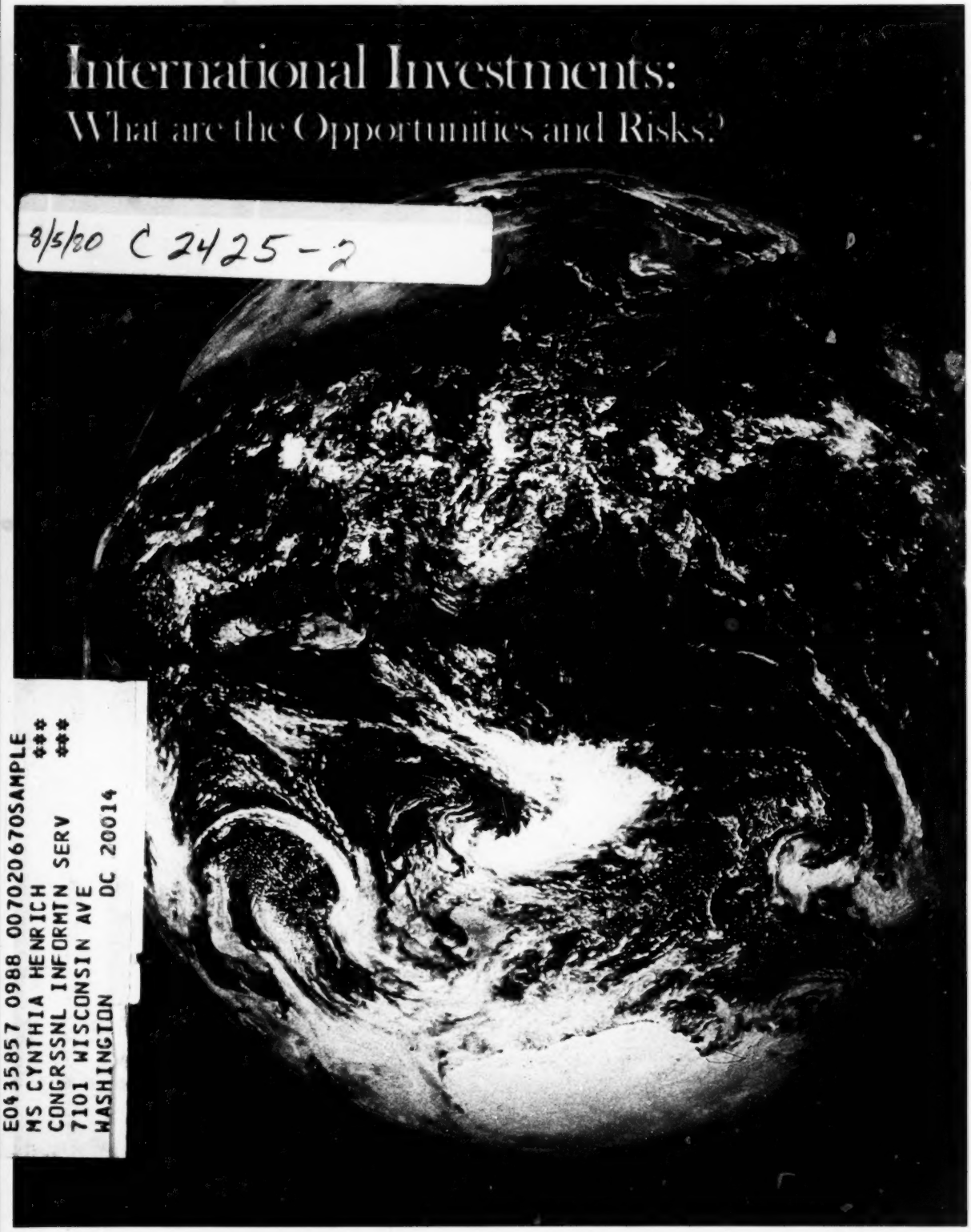
ESTATE PLANNING & ADMINISTRATION
A Publication of Communication Channels, Inc. AUGUST 1980

International Investments:
What are the Opportunities and Risks?



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TRUSTS & ESTATES

Volume 119, No. 8 AUGUST 1980

Estate Planning and Administration Since 1904

6 **Foreign Investment: Operations and Reporting Perspective**
Increased international investments cause new headaches for bank officers — *Mark S. Garbin and David M. Kinard*

15 **International Equity Management**
Turning to overseas markets can reduce risks for some American investors — *Landon Thomas*

22 **Statistical Sampling Can Help Trim Operating Costs**
New regulations allow sampling methods in verifying assets — *Gordon B. Harwood and William S. Saville*

26 **Choosing Executors and Trustees**
Care should be taken in selecting banks or individuals to handle estate matters — *Eustace W. Buchanan*

31 **Gold: The Glitter Remains**
In uncertain times, investors often turn to precious metals — *Mark E. Battersby*

34 **Family Partnerships Can Save Tax Dollars**
Income may be shifted to lower-taxed individuals — *Terry R. Perkins*

36 **Group Life Assignments**
Group life benefits may be kept out of an estate — *Marc A. Bergman*

43 **Complexities of Estate Planning Can Baffle Clients**
Planners should take care in providing basic information — *Borgny Baird*

REGULAR FEATURES

4 Opinion
40 Meetings & Conventions
46 Human Drama
50 Law and Life Insurance
52 Fiduciary Decisions
54 Trust Taxes
56 Personnel Changes

COVER

This month's cover features a spectacular view of the earth to illustrate the theme of international investments. Apollo 17 Astronaut Ronald E. Evans took the photograph as he and Astronauts Eugene A. Cernan and Harrison H. Schmitt traveled toward the moon. The photograph comes to us courtesy of the National Aeronautics and Space Administration.

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International Equity Management

Turning to overseas markets can reduce risks for some American investors

by LANDON THOMAS
Executive Vice President
Fiduciary Trust Company
New York, N.Y.

Landon Thomas joined Fiduciary Trust Co. of New York in 1960. He was elected a vice president in 1966 and was named executive vice president in charge of the international department in 1968. He was elected to the bank's board of directors in 1976.

Thomas was graduated from Harvard University and did post-graduate work at Centre d'Etudes Industrielles in Geneva.

American investors have shown little interest in portfolio investment outside their own country. This is not surprising in view of the tremendous economic strength and market opportunities available in the United States. The American investor, with every conceivable investment vehicle at his disposal, is immersed in a surfeit of statistics and information of all kinds and can rely on the SEC to protect him from some of the less obvious hazards of investing.

The interest equalization tax, introduced in 1963 and continuing until 1974, effectively put all thought of direct international investment diversification out of the minds of U.S. investors. Still, the typical American individual and institutional account has long been invested in multi-national corporations and most of these companies are well managed and have developed profitable markets around the world. To this extent the investor has been introduced to opportunities abroad.

There are many advantages for the investor through a direct international approach to investment management, and one of the most important is reduction of risk.

International diversification should be viewed first from the defensive. It is important to avoid undue risk. Aside from the fact that diversification always has been prudent, it can be demonstrated, again with indicies, that over the past 10 years, an internationally diversified portfolio has resulted in less volatility than one limited to a particular national market.

Chart 1 demonstrates these points. A line representing an imaginary account, 70 percent of which has been invested arbitrarily in the S&P 500 index and the remaining 30 percent in the Capital International Europe, Australia and Far East index, has been superimposed on the domestic and international indicies. The diversified account, following the blue line, generally is less volatile than either of the two indicies over the 10-year period.

Capital International S.A., to whom the authors are indebted for many of the accompaning charts, is an established group based in Geneva and whose indicies are broadly accepted throughout the world. The Capital International Europe, Australia and Far East index is an arithmetical average weighted by market value of some 450 companies representing 12 European countries. The market value of the companies included in this index was $434 billion as of March 1, 1980. We will have further reference to the service.

Incremental Return

A second important consideration is the incremental return from international investment.

There is no doubt that, based on a comparison of indicies, a higher return over a 10-year period has been obtained by portfolio investment overseas. In spite of the alternative of a passive approach through index funds, the Fiduciary Trust Co. believes that careful portfolio management still can produce better results over a reasonable period of time. Chart 2 demonstrates this by a comparison of domestic and international indicies — in local currency and dollars — with the Fiduciary non-U.S. aggregate performance.

Diversification is the essence of prudent portfolio management. If it is

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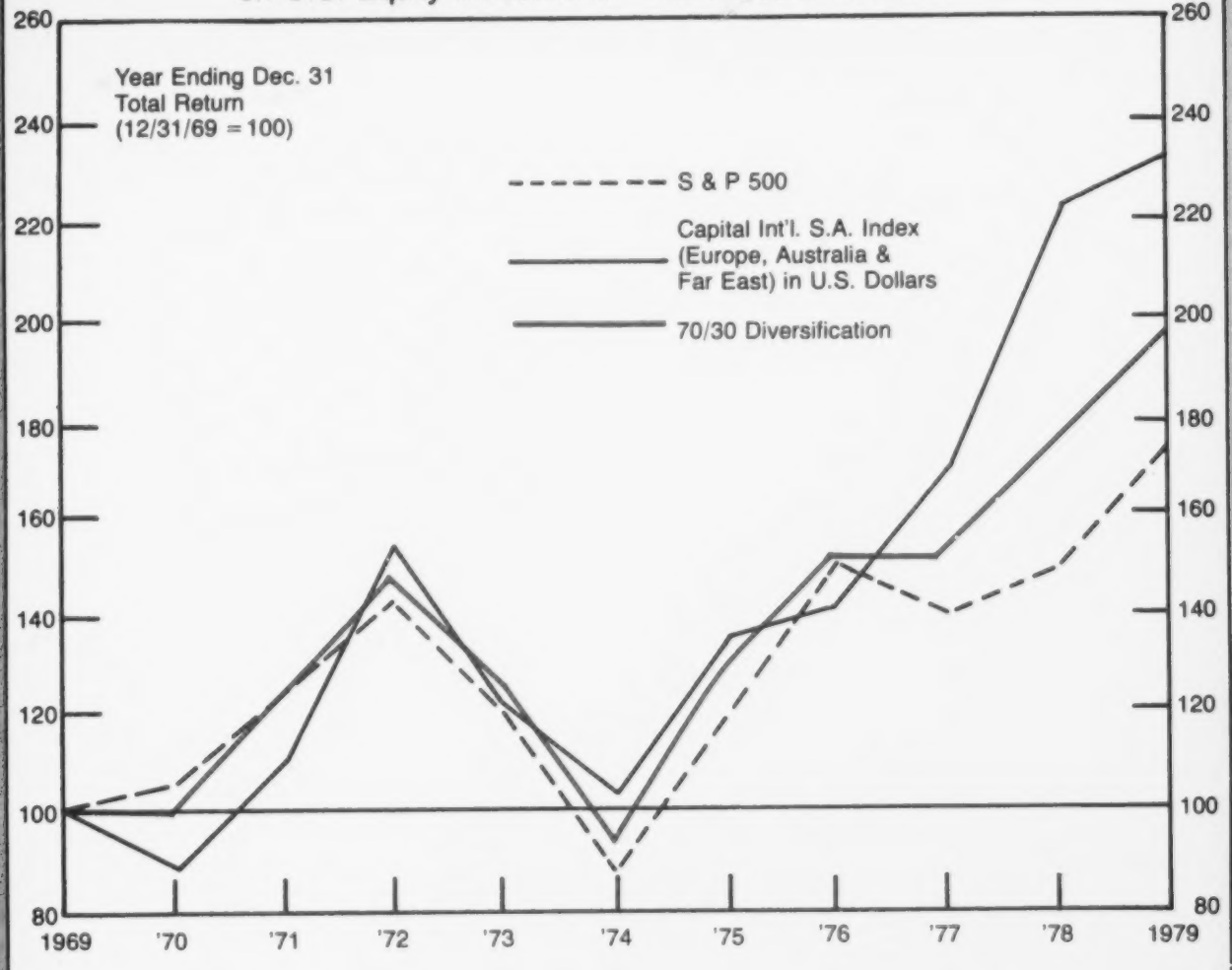
CHART 1

Effect of International Diversification on U.S. Equity Investment — 30 Percent Non U.S.



ANNUAL % CHANGE	70	71	72	73	74	75	76	77	78	79	10YR.
70/30 DIVERSIFICATION	(0.9)	19.3	24.2	(14.5)	(25.5)	36.7	17.6	0.5	14.4	14.5	7.0
CAPITAL INT'L. S.A. INDEX (EUROPE, AUSTRALIA & FAR EAST) IN U.S. DOLLARS	(12.2)	30.4	36.3	(14.9)	(23.2)	35.4	2.5	18.1	32.6	4.7	8.8
S & P 500	3.9	14.3	19.0	(14.7)	(26.5)	37.3	24.0	(7.1)	6.6	18.5	5.9

wise to invest among industries, companies and even different securities of one company in the United States, it is logical to consider the same choices in other free-enterprise economies. Furthermore, the willingness and ability to evaluate political and economic conditions in other countries can be useful even to the investor limited to the United States.

It is of paramount importance to select and emphasize those markets which promise the best returns combined with historically low volatility and with little correlation to market indicies in the United States.

Don't Become Too Concerned

Once a position has been taken on the outlook for a country's economy and the conclusion is at least moderately positive, it is important not to become too concerned with the uncertainties — both political and economic — which always come to mind when peering into a neighbor's backyard.

In Fiduciary's experience, the best approach to international investment is through careful study of an industry's future within its domestic market and in a worldwide context. Careful research analysis of every individual investment is the final step in the decision-making process.

Most of the same analytical and portfolio standards are applied to non-U.S. investments that are applied to stock selection in the U.S. Balance sheet and earnings considerations are essentially the same. Regulatory problems are given equal weight and cyclical aspects are evaluated as they are in

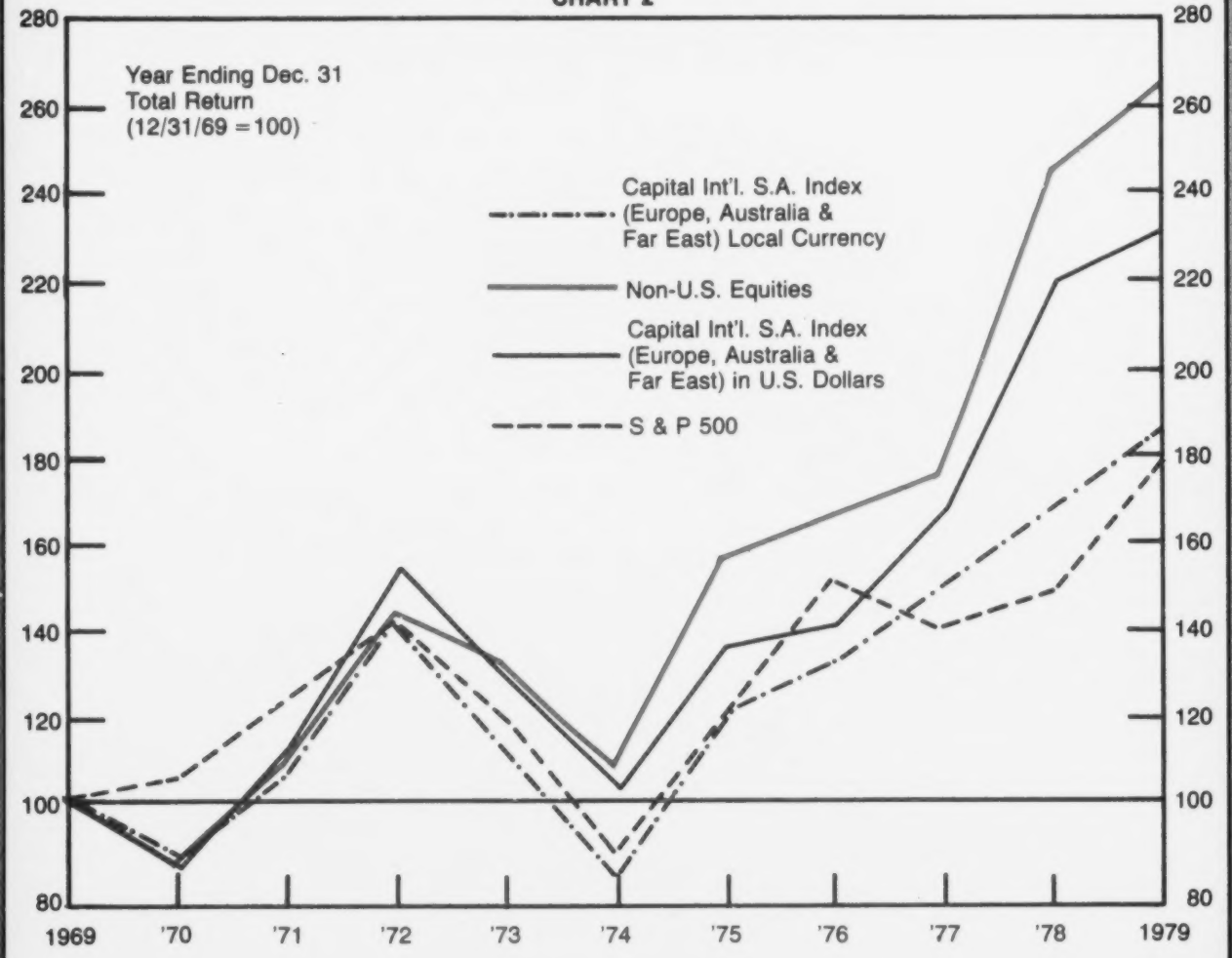
every institution on Wall Street.

The one important difference is that stocks are chosen with the alternative U.S. value very much in mind. There is no reason to search for high technology in data processing if it is clear that IBM remains a world leader. On the other hand, if an equity investment in another country can provide participation either in an industry or in a company which measures favorably with the opportunities in the U.S., there is every reason to consider such an investment favorably.

A good example in recent years has been high-technology companies in Japan, particularly the semi-conductor industry. Based on highly successful proprietary research and development, Japanese companies have captured an increasing share of world markets and now compete effectively with industry giants in the United States.

Australia offers by far the best opportunity for investment in minerals. The country is a high-grade, low-cost producer and the mining sector is based on the rapidly growing and resource-hungry economies of the Pacific Basin. Western Mining is the world's fourth largest producer of nickel with a profitable exposure to gold and aluminum.

CHART 2



ANNUAL % CHANGE	70	71	72	73	74	75	76	77	78	79	10YR
NON-U.S. EQUITIES	(10.8)	23.5	30.0	(8.8)	(18.8)	49.6	6.7	6.0	36.3	7.9	10.2
S & P 500	3.9	14.3	19.0	(14.7)	(26.5)	37.3	24.0	(7.1)	6.6	18.5	5.9
CAPITAL INT'L. S.A. INDEX (EUROPE, AUSTRALIA & FAR EAST) IN U.S. DOLLARS	(12.2)	30.4	36.3	(14.9)	(23.2)	35.4	2.5	18.1	32.6	4.7	8.8
CAPITAL INT'I. S.A. INDEX (EUROPE, AUSTRALIA & FAR EAST) LOCAL CURRENCY	(11.6)	18.4	35.8	(20.4)	(24.4)	42.2	5.3	4.7	14.9	9.4	6.2

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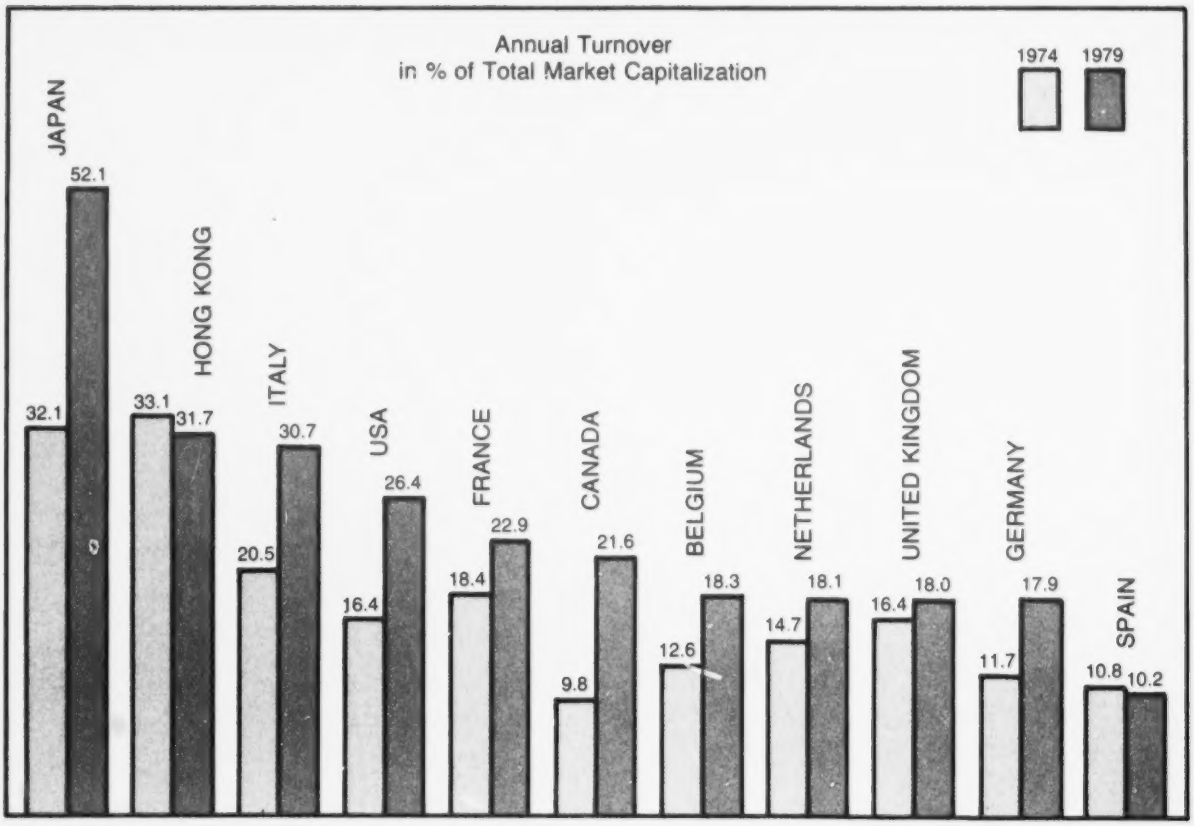
CHART 3



Note: Turnover data refers to common stocks only It includes foreign shares listed, except in Germany and the Netherlands.
Capital International Perspective 3'80 Geneva Switzerland

Although results are dependent largely on demand for nickel, the company has huge underdeveloped prospects for uranium and copper. Compared to International Nickel, a far larger and more mature company, Western Mining is a logical choice.

Broken Hill Proprietary (BHP) is a unique investment in many ways. Aside from being the largest integrated steel company in Australia — the division also is profitable — BHP is an excellent natural resource company with heavy and extremely profitable emphasis on oil and natural gas. Over the longer term the company's interests in coal, maganese, iron ore, tin and gold offer considerable potential as well. In this case, there are no alternative invertments offering such a diversified spread of natural resources. (Table 1)

Fiduciary historically has emphasized the financial sector outside the United States. Insurance stocks overseas have performed well on a comparative and absolute basis. Industry leaders have dominated their domestic markets and aggressively taken on profitable international risks. Results have been relatively free from the traditional underwriting cycles and there has been every incentive for the international investor to emphasize companies such as Nationale Nederlanden and Tokyo Marine. (Table 2)

"Insurance stocks overseas have performed well on a comparative and absolute basis."

There are many similar examples farther afield. For those who are looking for a fairly undiluted investment in the prospects for North Sea oil, Petrofina, a Belgium-based company, should be measured carefully against the various international oil companies with interests in that part of the world. Norsk Hydro, although basically a cyclical chemical/metal company, has a significant interest in proven reserves in the Norwegian sector. Oil and natural gas earnings should have a tremendous impact on overall earnings.

The process of weighing alternatives also should be extended to industries. In the recent past the problems of the U.S. banking industry have been very much in evidence and the stocks of many of these companies have not been in favor.

The banking industry in many countries overseas, while certainly affected by some of the difficulties besetting U.S. banks, have been in an essentially better position. The German universal banks operate in an entirely different banking system and can engage profitably in many areas of financial opportunity from which U.S. banks have been excluded for a long time.

In Southeast Asia, it is even possible to invest in a bank which performs essentially the function of a central

Table 1

Natural Resources	1975	1976	1977	1978	1979	5-year
			Local Currencies			
Broken Hill Proprietary	+38%	+11%	−21%	+55%	+58%	+198%
Western Mining	−12	+11	−22	+41	+74	+ 87
International Nickel	+ 7	+ 9	−48	− 3	+51	+ 10

bank. Both the earnings and stock market prices, even in local currencies, of these banks over the past five years have far outperformed their American equivalents. (Table 3)

Liquidity is highly important and there has been much criticism of the lack of it in overseas markets. The worldwide economic domination of the U.S. is reflected in the market capitalization of other countries. The Capital

Table 2

Insurance	1975	1976	1977	1978	1979	5-year
			Local Currencies			
Nationale Nederlanden	+75%	− 2%	+22%	+11%	−14%	+165%
Tokyo Marine	+19	+38	−13	+ 1	+40	+102
Aetna Life & Casualty	− 1	+51	+ 3	+ 6	−14	+ 43
General Reinsurance	−12	+25	−11	+ 4	+10	+ 12
A.I.G.	+20	− 5	+ 7	+22	+17	+ 74

International figures clearly show that the bulk of the investments of an internationally invested portfolio should be in the United States.

Great Majority U.S. Based

The fact that the great majority of investments of the ideal portfolio should be U.S. based cannot be overlooked. To some extent, the schedule in Table 4 suggests a rough guideline to the limits of the commitments that could be made around the world.

Measured on market capitalization, the difference is huge between the U.S. and, say, the Netherlands and Hong Kong. On the basis of that measurement alone, it would be easy to exclude any investment in these countries. Using a different measurement — that of a turnover in percent of total market capitalization — the situation appears in a more favorable light (Chart 3).

The conclusion would be that turnover in other markets is not out of line with United States markets.

Liquidity considerations in other markets do not necessarily dictate investment emphasis. There is just as much potential risk in other diversification in the U.S. equity markets as there is in needless investment concentration in overseas markets. Neither extreme is necessary.

Suitable investments are available in other markets and a portfolio can be spread broadly while still concentrating on companies which offer better rewards. Fiduciary Trust Co. places investment emphasis on companies of particular interest. Of some 90 issues in the aggregate non-U.S. portfolio, the 20 largest holdings amount to just over 40 percent of the total market value.

There can be no doubt that liquidity always will be a problem for investors, not only in markets overseas, but also in all equity markets when buyers are hard to find.

Since the end of 1970, floating currencies have beome a part of international financial transactions. They not only concern corporate treasurers, but also the international portfolio investor. Currency regulations alone must not rule the investment decision-making process. The strength or weakness of a currency is important and will have an affect on any investment, but it still is essential to evaluate the fundamental prospects of an industry and a company.

Once satisified as to the basic value of an equity investment, one can properly put it into the context of the home country's current economic situation. It is comforting to observe that the economic management of a country still is the main factor influencing the fluctuations of its currency.

Currency values will reflect the basic health of a national economy over the longer term, and this has held true as monetary systems have come and gone. If the fundamental merits of the economy, industry and company have been judged correctly, the currency sooner or later will take care of itself.

The situation of the U.K. in 1974 demonstrates the risk in basing investment decisions on currency considerations alone. At the end of 1974, there was general agreement that pound sterling was overvalued at £ = $2.35. At the same time the Financial Times index stood at 161 after a violent drop over the preceding months. By the middle of December, 1977, pound sterling conveniently had justi-

Table 3

Banks	1975	1976	1977	1978	1979	5-year
			Local Currencies			
Deutsche Bank	+ 35%	−18%	+ 8%	+ 3%	−13%	+ 10%
Dresdner Bank	+ 52	−12	+ 7	+ 2	−20	+ 17
Algemene Bank	+ 38	+ 4	+13	+17	− 7	+ 75
Amro Bank	+ 30	− 5	0	+16	− 5	+ 36
Hongkong & Shanghai Bank	+145	+25	− 8	+10	+65	+411
Union Bank of Switzerland (bearer)	+ 74	+ 8	+ 6	− 6	+16	+117
Development Bank of Singapore	+ 87	+26	− 9	+12	+32	+217
Malayan Bank	+ 60	+41	−16	+36	+32	+352
National Westminster	+145	− 7	+25	− 1	+25	+252
Morgan (J.P.)	+ 3	+ 5	−24	+ 6	+ 2	− 8
Citicorp	+ 4	+11	−30	+ 3	+ 1	− 9
Chase	+ 2	+11	− 2	− 2	+31	+ 43
First Chicago	+ 5	+28	−19	+ 3	−16	− 10

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fied the suspicions of all concerned by a fall of 24 percent to £ = $1.90.

Unfortunately for those who had correctly foreseen the pound's fall, and on that basis sold U.K. equities at the end of the 1974 year, the recovery in the Financial Times index of 201 percent to a level of 485 at the end of 1977 would have been missed.

Currency Considerations

Currency considerations, while part of the investment process, should be taken in their proper context. The effect of currency fluctuations on portfolios reporting in U.S. dollars can be significant in any given year, but over a longer period of time the difference is not extraordinary.

In Chart 2, the Capital International Europe, Australia and Far East index, as expressed in local currencies, compares with the solid black line which represents the performance of the index after conversion to U.S. dollars. The currency gain accruing to investors who benefited from the relative strength of local currencies was important, but should not obscure the strong growth of the index in local currency terms.

Two of the many other factors that the prospective international investor should consider will serve to round out the picture. The question of corporate information, or lack of it, often has been raised and now can be answered with far more conviction than was possible 10 or 15 years ago.

Corporate reporting precedures have improved greatly around the world and there have been a number of moderately successful attempts to introduce market supervision and controls. In every country of investment interest there are many excellent financial institutions which have become more and more familiar with worldwide portfolio investment.

Fiduciary has found that with the help of long-standing correspondent friends in countries where we are engaged, we never have suffered a serious shortage of corporate information. We always have been able to conduct our own independent basic research analysis on any country in which we have a commitment.

There generally is no difficulty in gaining access to management and corporations which have become far more conscious of investor relationships.

Administration and reporting also should not be overlooked. It is vital to any successful investment program, no matter where, to have established an efficient custodial, administrative and reporting system. Fiduciary has had no difficulty in establishing such systems with the help of leading financial institutions around the world. It is entirely possible to produce investment appraisals in a format consistent with the demands of American individual and institutional investors.

This article may serve as an introduction to investors who would like to consider international diversification as a prudent means towards achieving a higher return and significantly reducing risk. If the program sounds complicated, the first step might well be to diversify the bond section of a U.S.-invested portfolio. The incremental returns can be measured in basis points, proven statistically, and there is no language problem with numbers. □

Table 4

Capital International Indices

(as of March 31, 1980)

	Companies Included in Indices					
	Number	Market Capitalisation	Europe	E.A. & F.E.	World	Market Coverage of Indices
U.K.	105	$ 90.9 bill.	38.4%	20.9%	9.2%	64.3%
Germany	67	47.4 bill.	20.0	10.9	4.8	69.8
France	78	27.2 bill.	11.5	6.3	2.8	57.5
Spain	20	7.6 bill.	3.2	1.8	0.8	47.7
Switzerland	28	23.3 bill.	9.8	5.4	2.4	61.7
Netherlands	22	16.0 bill.	6.8	3.7	1.6	79.2
Italy	43	7.7 bill.	3.3	1.8	0.8	58.0
Belgium	26	7.1 bill.	3.0	1.7	0.7	68.0
Sweden	22	4.9 bill.	2.1	1.1	0.5	48.8
Denmark	15	1.4 bill.	0.6	0.3	0.1	47.3
Norway	10	1.8 bill.	0.8	0.4	0.2	80.4
Austria	9	1.3 bill.	0.5	0.3	0.1	65.0
Europe	445	$236.6 bill	100.0%			63.7%
Japan	191	158.7 bill.		36.5	16.1	60.6
Hong Kong	20	11.5 bill.		2.6	1.2	58.6
Singapore	36	5.7 bill.		1.3	0.6	41.2
Australia	64	21.7 bill.		5.0	2.2	56.9
Europe Australia & Far East	756	$434.2 bill.		100.0%		61.6%
U.S.A.	268	490.3 bill.			49.9	54.8
Canada	60	49.6 bill.			5.0	51.5
South African Golds	23	9.6 bill.			1.0	45.6
World	1,107	$983.7 bill.			100.0%	57.3%

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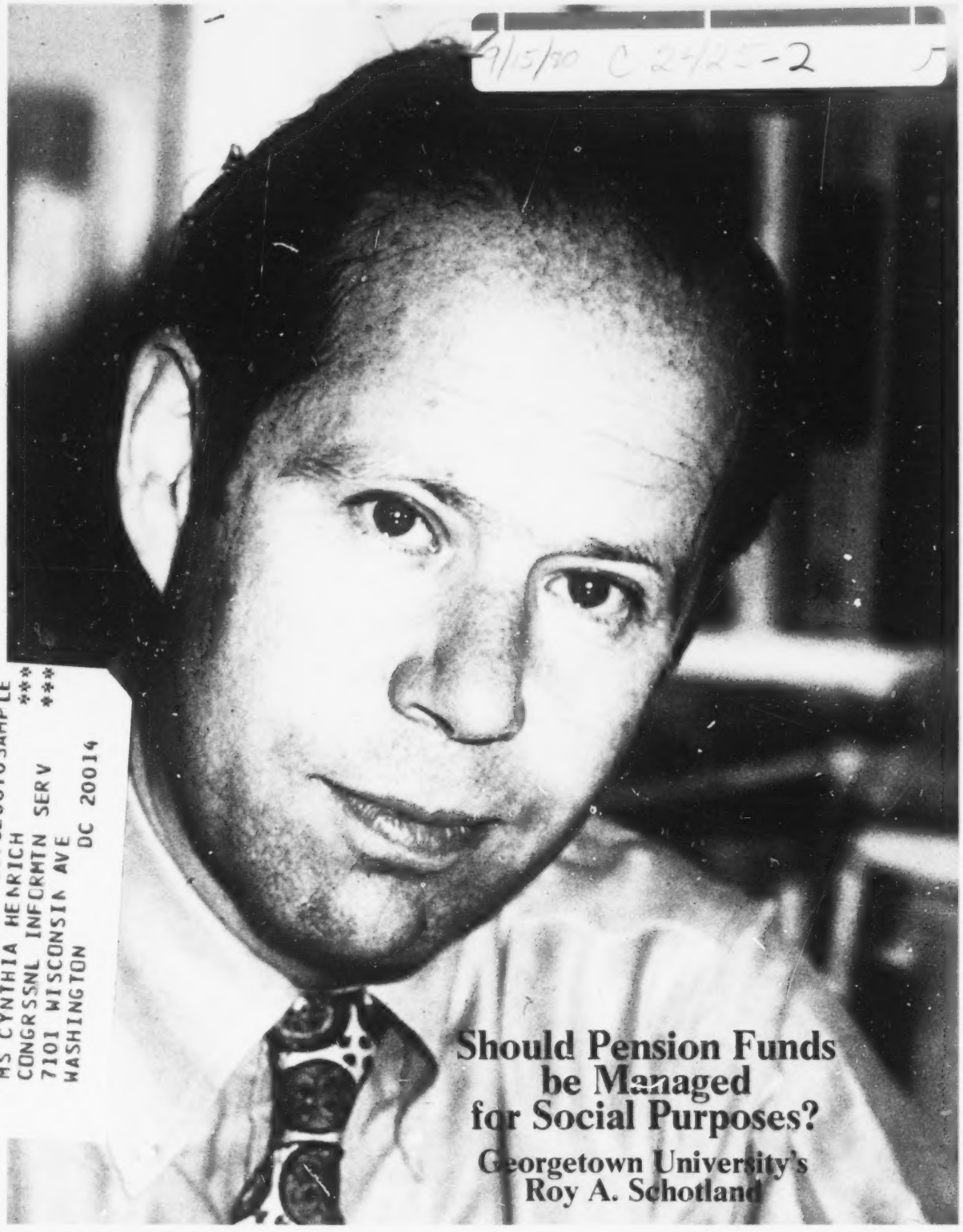

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Should Pension Funds be Managed for Social Purposes?

Georgetown University's Roy A. Schotland

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TRUSTS & ESTATES

Volume 119, No. 9 SEPTEMBER 1980

Estate Planning and Administration Since 1904

10 / **Divergent Investing for Pension Funds, Part I**
Should funds' funds be used for "social" purposes? *Roy A. Schotland*

27 / **Can Rushing Survive?**
Government heats up attack on method of avoiding taxes in corporate liquidations *Howard Eichenbaum*

41 / **Conservation and Preservation Easements Reduce Taxes and Protect Property**
Properly structured, such easements can save tax dollars and preserve historic land *James M. Dillon*

46 / **Financial Planning When Death is Imminent**
Using a checklist will help to avoid costly oversights *Thomas M. Porcano and Wayne C. Staton*

57 / **Assignment of Group Term Life Insurance to Irrevocable Trusts**
A further look at protecting group insurance proceeds from estate taxes *Alan F. Hilfiker*

65 / **Classic and Antique Cars**
Appreciation in value can be substantial, but potential investors should seek expert advice *Mark E. Battersby*

68 / **Philanthropy and Estate Planning**
Many technical requirements must be met to get income and gift tax deductions for charitable remainder trusts *Conrad Teitell*

70 / **Institutional Investor**
Two new ideas for the investing of institutional fund assets *Robert S. Waill*

COVER

Our cover story this month is the first in a three-part series by Roy A. Schotland, professor of law at Georgetown University Law Center, Washington, D.C. Schotland explores the question: Should pension plans be managed for social purposes as well as to insure the security of their beneficiaries? (Photo by Walter H. Sonnenfeldt)

REGULAR FEATURES

4 Opinion
6 Letters to the Editor
72 Law and Life Insurance
74 Recommended Reading
76 Personnel Changes
78 Fiduciary Decisions
81 Meetings & Conventions
83 Maxims and Minims

First of Three Parts

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Should Pension Funds be Used to Achieve "Social" Goals?

by ROY A. SCHOTLAND
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One of those more-heat-than-light issues is "social investing," the question of whether pension funds should diverge from their traditional goal of maximizing investment return at an appropriate level of risk in order to pursue other goals.

Analysis suffers from the outset if the label "social" or "socially responsible" investing is accepted. Few minds will be open to any plea for the anti-social or irresponsible, and hardly any more will think "let the market decide" a sufficient answer. But further, the "social" label is over-broad. Everyone agrees that investing for retirement security itself is a socially responsible goal. More accurate labels would be "alternative" or "divergent" investing, since the proposal is to tap pension assets for goals other than retirement security.

Some advocates of alternative or divergent investing do not go so far as to advocate any step — whether it would involve seeking out favored investments, or avoiding disfavored ones — which might impair a pension fund's pursuit of protecting retirement security. Other advocates are prepared to diverge quite openly from the traditional exclusive primacy of retirement security.

Whatever the label, surely it sounds attractive to invest both to protect retirement security and to promote such other goals as equal employment opportunity, or environmental quality, or local jobs or housing. If "Investment XX" has as high a return and low a risk as other clearly appropriate investments, but XX also promotes common concerns of the pension fund's beneficiaries, then the only investment manager who wouldn't buy XX for that fund would be a misanthrope, hating both his clients and his own firm's future. Obviously, XX has more bang for the buck.[1]

Some optimists believe there are enough XX-type investments available, and that pension fund selection of such investments is so feasible and would have such beneficial impacts without any impairment of retirement security, that no real dispute exists between traditional prudent investing and advocates of alternative divergent investing.

Whether I am a pessimist or a realist, I fear that more than a failure of communication underlines the dispute here. The controversy is genuine because, for one reason, not all advocates of divergent investing will settle for XX-type investments, since by definition such investments can meet market levels of return, and some advocates' whole point is that there are worthy needs which cannot meet market tests and therefore should be subsidized by the deepest pocket available, pension assets.

Of course the market system leaves some worthy needs unsatisfied, and I agree that many of these needs warrent government intervention. I am not one of those who believes that markets provide the best answers to all problems, except the three obvious needs for collective action — traffic lights, an army and subsidy to my own business.[2]

But not only do I believe that tapping pension assets for hidden subsidies to further other goals is an especially ineffective way to pursue those other goals, more importantly, I reject any divergence from protection of retirement security.

Even with the moderate advocates of divergent investing, who also reject any impairment of retirement security but believe the true path is to pursue what I have labeled XX investing, there are real differences and not merely poor communications. For XX investing is so obviously desirable that it must suffer some hitch or it would sweep the field on its own, without advocacy.

There are a number of obstacles to be overcome before we get to the happy state in which all funds so inclined can buy as much as they wish of XX investments, which actually promote alternative goals without subsidizing those goals at the expense of the retirees, or the pension sponsors, or both. The various difficulties of implementing any divergent investing include which goals shall be pursued, what is the priority among them and who decides.

After hurdling these obstacles, one comes to the problem of identifying which investments have the desired something extra, conflicts of interest between the fund and the "target" of the divergent investment, measuring how well the investment contributed to the divergent goal and trying to ignore the contribution to that other goal while evaluating how the investment performed for the pension fund, lest the exclusive primacy of retirement security begin to erode.

These problems of implementation, considered fully below, are reminiscent of the old cartographic problem of mapping Utopia, which is described as an incomplete circle of 50 miles in circumference with a width of 200 miles,

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"While it might be possible to draw a non-Euclidean map of Utopia . . . no one has done so, even though many of us do not like the shape the world is in."

— Roy Schotland

a combination not permissible in Euclidean space.

While it might be possible to draw a non-Euclidean map of Utopia, an obvious course, no one has done so, even though many of us do not like the shape the world is in. Implementing divergent investing may seem equally feasible until tried. It is just like Will Rogers' formula for getting rich in the stock market: "Buy a good stock and hold it 'till it goes up, and then sell it. If it don't go up, don't buy it."

A Bit of History

Before focusing on the basic objection to divergent investing and the various implementation problems that limit even XX investing, we should note the history of this idea, for it not only gives us a sense of context, but, unsurprisingly, brings out several of the most important points at the outset.

Ten years ago, Wright Patman was pushing a bill to require private pension funds to invest as much as 2½ percent of their assets *each year* in low- and middle-income housing. Congresswoman Martha Griffiths chaired Joint Economic Committee hearings to explore whether pension funds should be directed by law into "socially responsible" investments.[3]

While the federal scene since has been free of this debate, there are recurrent proposals, some with pressure behind them, aimed at state and local pension funds.[4] But the earliest, most complete and most illuminating bit of history comes from one state.

The earliest explicit advocacy of divergent investing was in 1931 in Wisconsin, when a state assemblyman proposed to have the state teacher's retirement fund emphasize investment in Wisconsin farm mortgages. The assemblyman said that the fund's board had "more confidence in the Dominion of Canada, Puget Sound and God knows where than in the state of Wisconsin."

Further inquiry revealed that although the fund's 10-year losses on farm loans had been less severe than their losses on bonds (remember, this was 1931), the number of such loans had been reduced. In 1932, the Democratic candidate for governor pledged to "wrest control of the state investment board from big business and replace it in the hands of the people to be operated for the public good."

That candidate won, and a bill was passed mandating that at least 70 percent of trust monies be invested within Wisconsin. It specified preference for small loans on improved farm property, loans to cooperative and mutual organizations, and town mutual insurance company mortages, in that order of priority.

That statute mandating in-state preference was repealed in 1945. As admitted by a recent report advocating resurrection of such treatment, "the performance level of the Wisconsin portfolio may have had a bearing on the (repeal) . . ."[5]

In 1949, investment of state funds again became a major issue, and a study commissioned by the governor revealed that the state still was not performing as well as private investment managers with funds of similar size, because the state's investment policies still were not sufficiently diversified. By 1951, a major overhaul of the retirement fund structure was in place, including a great increase in investment flexibility.

For me, this bit of history makes seven points.

First, divergent investing is not a new notion, but one which has been around and around, and its almost complete rejection in actual practice says much.

Second, divergent investing is, in fact, hardly worth the effort to get it into place if it involves picking merely the limited number of what I call "XX-type" investments. The effort is likely to be aimed at using pension assets to subsidize other goals.

Third, subsidizing other goals costs money and the pension fund will perform less well.

State and Local Funds

Fourth, the funds most vulnerable to divergent investing are the state and local funds. They combine political vulnerability with unusually large assets, making it more worthwhile to bring pressure on them. New York's and California's public funds alone exceed $35 billion in assets. The top 25 public funds hold $99 billion, in contrast to the other group vulnerable to pressure for divergent investing, Taft-Hartleys, where the top 25 hold $11 billion. If private pension professionals care about this issue, they will not lie back while their state and local funds — in which they have interests as taxpayers as well as professionally — are pressured into diverging from protection of retirement security.

Fifth, divergent investing is likely to be tried here and there, now and then, until the lesson is learned that this is just one more situation proving there is no free lunch.

Sixth, injecting divergent goals into traditional pension investing is likely to follow the Law of the Austro-Hungarian Generals: "Always fight the last war, aiming with the perfect accuracy of hindsight." The unmet social needs which are likely to be injected into the pension program are inescapably those which have been around long enough to build up a constituency, and by the time they succeed in diverting the pension investment strategy to trying to do what should have been done openly and directly by some other instrument at some earlier time, the odds are high that needs have changed, markets have

changed, and so there is even less likelihood of the divergent investment's accomplishing its divergent goal, whether or not it imposes lower return on the pension fund. Vulnerable as are investment professionals themselves to this same Law of the A.-H. Generals, far better to maximize flexibility and prudent professionalism than to inject and preserve the war cries of fading causes.

Seventh, if and when divergent investing is tried, two safety factors must be put in with it: (A) Use only a modest portion of the assets, not all. If in fact the program does work, despite my analysis of all the reasons it won't, then the assets so used can always be increased. If it doesn't work, the lesson is learned at a much lower cost. (B) Do not reduce investment flexibility. As the recent Wisconsin report advocating divergent investment acknowledged, "A major drawback to this approach (of statutorily defined priorities) is that it might reduce the (state investment board's) flexibility in making investments. To be held to even semi-rigid guidelines laid down by statute could result in an inability to act prudently in times of economic change."[6]

". . . if and when divergent investing is tried, two safety factors must be put in with it . . ."

Divergent Investing's Advocacy

If divergent investing really won't work, and if its advocacy keeps coming up but takes hold in practice little if at all, why not ignore it? Because, for one reason, to the extent that divergent investing is tried, it is too likely to impair investment performance, and therefore impair retirement security, or the fiscal health of the fund's sponsor, whether public or private. Efforts to avoid such impairment seem to me part of the fiduciary's obligation.

For another reason, even debate over this issue is an unproductive distraction from the real issues and tasks of the pension world; the simple ones like improving communications to participants, improving investment managers' reporting of their performance results and making governance of pension funds more representative; or the tough current challenges like coping with inflation, coping with unfunded liabilities, deciding how to provide multi-employer plans with termination insurance, improving private pension benefits' intergration with Social Security so that we avoid a tax-subsidized private pension scheme providing benefits mainly to upper-income people who least need such subsidy, and bringing local pension plan norms into the modern era.

The sooner we do the educating necessary to put the divergent investing issue back on the shelf, the sooner we get back to problems needing much analysis and generating such controversy as to merit all the energy we can bring them.

Advocacy of divergent investing won't stop unless the notion's unreality and unsoundness are made clear. One force raising the issue is that it does sound so attractive — "all other things being equal, why not invest for other goals as well as retirement security?"

It takes some familiarity with finance to understand just how fallacious a notion this is, and neither familiarity nor sympathy is increased when pension professionals respond with various neanderthalisms, such as "we must pursue only financial returns," or "we must protect the solvency of the fund,"[7] as if the fund mattered more than its beneficiaries, or as if the beneficiaries' only concern is financial return. Pension professionals must muster more patience and more persuasiveness to meet the wholly sincere concerns which produce much of this advocacy.

Importantly fueling this advocacy is the hope to get around the clash between the need to meet our society's problems and the limited resources available to meet them.[8] At least since 1973, when the sheiks of Araby took revenge for the 19th Century (to use Giscard d'Estaing's immortal phrase), our economy is not growing as it had for the prior generation, and slower growth means more scrapping over who gets how much.

Pension assets are so huge — over $400 billion, not counting federal pensions — they are bound to be visible, bound to seem an available resource and bound to seem ever more ripe for tapping as they grow faster than almost any other sector of the economy.

Private pension assets are rising more than 10 percent each year and state and locals are increasing 12-15 percent annually.

Third Force

A third force fueling this advocacy is the sad truth that traditional prudent pension investing has not done well at winning those financial returns which, it is argued, must be the exclusive concern if retirement security is to be protected. Everybody knows that our economy, and therefore our securities markets, have done poorly in recent years. But the mediocrity of pension investment performance cannot be so easily excused.

Before considering the striking inferiority pension fund performance data reveal when compared to mutual fund performance data, three points must be noted. First, the data below are limited to equity performance only. All mutual funds combined hold only about 10 percent of their aggregate assets in fixed-income securities, not counting money market funds and municipal bond funds.

Therefore, it seems meaningless to compare total portfolio performance and immaterial to compare fixed-income performance.

Second, one of the main themes in the art of argument, whenever confronted by any comparison, is to stress how many differences exist which undercut the comparison. But if the comparison shows a substantially greater difference than would have been expected (or, depending upon what point the comparison is being used for, if it shows a greater similarity), then the comparison's point must be met head on. The data may need adjustment and explanation, but they cannot be explained away.

Of course, the data below have limits, as noted in the lengthy footnote to the chart, but the performance differential these data reveal overrides any "corrective" adjustments.

Third, the inferiority of pension fund performance revealed here is confirmed by two new, but thorough and fair, studies done by mutual fund professionals and based on neutral data sources.[9]

Noting how inferior has been pension fund performance and speculating about the causes of such inferiority is only a point in passing in this paper, even if it is a point so important that the paper probably would be unnecessary if pension funds had performed well. But the need for research into

Table 1

Historical Risk Premium Evidence, Annualized 10-Year Rates of Return

Ten-Year Time Period	S & P Bond Index	25% Stocks	75% Stocks	S & P Stock Index
1900 Through 1909	4.5%	5.9%	8.3%	9.3%
1901 Through 1910	4.3	5.2	6.5	6.9
1902 Through 1911	4.2	4.7	5.4	5.4
1903 Through 1912	4.2	4.7	5.3	5.3
1904 Through 1913	4.3	5.1	6.4	6.8
1905 Through 1914	3.8	3.9	3.7	3.4
1906 Through 1915	4.0	4.3	4.3	4.2
1907 Through 1916	4.4	4.7	5.0	5.0
1908 Through 1917	4.1	4.6	5.5	5.7
1909 Through 1918	3.6	3.8	4.0	4.0
1910 Through 1919	3.1	3.5	4.1	4.3
1911 Through 1920	2.9	3.1	3.2	3.1
1912 Through 1921	4.0	4.1	3.9	3.7
1913 Through 1922	4.6	5.0	5.5	5.6
1914 Through 1923	4.7	5.4	6.3	6.6
1915 Through 1924	5.1	6.4	8.7	9.7
1916 Through 1925	5.1	6.3	8.3	9.2
1917 Through 1926	5.2	6.4	8.6	9.5
1918 Through 1927	6.5	8.8	13.2	15.3
1919 Through 1928	6.1	9.2	15.0	17.7
1920 Through 1929	6.4	8.7	12.8	14.6
1921 Through 1930	7.0	8.9	12.0	13.2
1922 Through 1931	5.2	6.1	6.7	6.3
1923 Through 1932	5.1	5.2	4.0	2.8
1924 Through 1933	5.7	6.7	7.2	6.7
1925 Through 1934	6.3	6.5	5.4	4.0
1926 Through 1935	6.6	7.2	6.7	5.7
1927 Through 1936	6.6	7.7	8.2	7.6
1928 Through 1937	6.2	5.6	2.6	0.1
1929 Through 1938	6.6	5.6	1.9	(0.8)
1930 Through 1939	6.8	5.9	2.5	(0.1)
1931 Through 1940	6.5	6.0	3.6	1.6
1932 Through 1941	7.0	7.3	6.8	6.0
1933 Through 1942	6.3	7.5	8.8	8.9
1934 Through 1943	5.7	6.5	7.0	6.8
1935 Through 1944	4.9	6.3	8.4	8.9
1936 Through 1945	4.4	5.7	7.6	8.1
1937 Through 1946	3.9	4.4	4.6	4.2
1938 Through 1947	3.4	5.1	8.0	9.2
1939 Through 1948	3.2	4.3	6.1	6.8
1940 Through 1949	3.3	4.8	7.5	8.6
1941 Through 1950	3.1	5.7	10.5	12.7
1942 Through 1951	2.5	6.2	13.1	16.5
1943 Through 1952	2.4	6.0	13.0	16.3
1944 Through 1953	2.4	5.4	10.9	13.6
1945 Through 1954	2.4	6.1	13.1	16.3
1946 Through 1955	1.9	5.7	12.7	16.0
1947 Through 1956	1.1	5.4	13.7	17.7
1948 Through 1957	1.9	5.6	12.6	15.9
1949 Through 1958	1.1	6.0	15.2	19.5
1950 Through 1959	0.3	5.3	14.6	18.9
1951 Through 1960	1.0	5.1	12.5	15.9
1952 Through 1961	1.6	5.6	12.9	16.2
1953 Through 1962	2.1	5.3	10.9	13.3
1954 Through 1963	2.0	5.8	12.7	15.7
1955 Through 1964	1.9	5.0	10.3	12.7
1956 Through 1965	1.9	4.4	9.0	11.0
1957 Through 1966	2.5	4.4	7.7	9.1
1958 Through 1967	1.3	4.4	10.1	12.6
1959 Through 1968	1.6	3.9	8.0	9.8
1960 Through 1969	1.1	2.9	6.2	7.7
1961 Through 1970	1.6	3.4	6.6	8.0
1962 Through 1971	2.0	3.4	5.9	6.9
1963 Through 1972	1.9	4.0	7.9	9.8
1964 Through 1973	1.9	3.0	5.1	5.9
1965 Through 1974	1.3	1.5	1.5	1.2
1966 Through 1975	2.3	2.8	3.3	3.3
1967 Through 1976	3.7	4.7	6.1	6.6
1968 Through 1977	4.5	4.5	4.0	3.5
1969 Through 1978	4.6	4.4	3.7	3.1

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this point, to explain why pension funds have suffered such inferior performance, is as irrefutable as the data themselves. (Chart 1)

For the purposes of this paper, suffice it to say that no refutation of divergent investing could be as convincing as strong investment performance via traditional prudent management. Unless and until we get such performance, we must argue, and from a defensive posture.

For purposes of argument against divergent investing, some pension professionals think the best answer goes along these lines: "First, get the participants to agree to change their plans from defined benefit to defined contribution so that the risk of any lower investment returns is borne wholly by the participants."

That, however, merely is a debater's point, since such a change is not readily made and we will not remove interest in divergent investing by debater's logic, but by demonstrating what works and what does not. We need research on the reasons for poor pension fund performance, and we need to take steps toward improving performance. Mediocre investment performance by the private pension system exposes it to arguments against traditional prudent investing, and even calls into question the justification for having a private pension system.

Even if the exclusive pursuit of investment returns had been more successful than it has been, the less that people know about investment the easier they find it to look back and say how clearly it would have been done better if it had been done differently. I am aware of no line of activity in which success and failure are so explicitly revealed as investment management. Today many second guessers scoff that savings accounts have done better than the stock market over so much of the last decade, and they are correct as far as they go. But how many such scoffers called any turn in advance?

". . . many . . . scoff that savings accounts have done better than the stock market . . ."

Their advice now may be as helpful as was the Ford Foundation's in 1968 when they urged university endowments to abandon as obsolete their conservative investment policies and instead enjoy the greater benefits of growth-stock investing, just as events were making that advice one of the worst strategies of all.

The fallacy of this hindsight is compounded by two errors in the advocacy of divergent investing. For one, today's relatively high yields on, say, inter-city mortgages are compared with actual, total investment returns over the last decade. But the 5-percent mortgage of as recent times as 1961-62, or the 7- to 8-percent yields of 1971-72 are ignored.[11]

Similarly ignored are the investment returns of the 1960s, or of the past 20 years, or the comparison between fixed-income returns and the returns on equities.[12]

How do we know whether the next

decade's total returns from traditional prudent equity investing (using the S&P 500 as a proxy) will average an annual rate of 3.1 percent as in the decade 1969-78, or instead the 9.8-percent result of the previous decade, or instead the glorious 19.5 percent per year of 1949-58, or instead results like one of these periods: 1967-76, 6.6 percent; 1965-74, 1.2 percent; 1958-67, 12.6 percent; 1954-63, 15.7 percent? (Table 1 & Chart 1)[13]

Indeed, of the 70 different 10-year periods from 1900, stocks outperformed fixed-income investments (using as a proxy the S&P high-grade corporate bond index) in 58 periods and underperformed in only 12. Seven of the 12 periods in which stocks underperformed were the Great Depression, but three of the remaining five poor periods were 1965-74, 1968-77 and 1969-78, and that recent experience is all some people think of.

Are those who would choose divergent investing over traditional prudent investing so determined to abide by the Law of the Austro-Hungarian Generals, is their hindsight so hampered by blinders, that they look exclusively at the immediate past and ignore the rest of our experience?

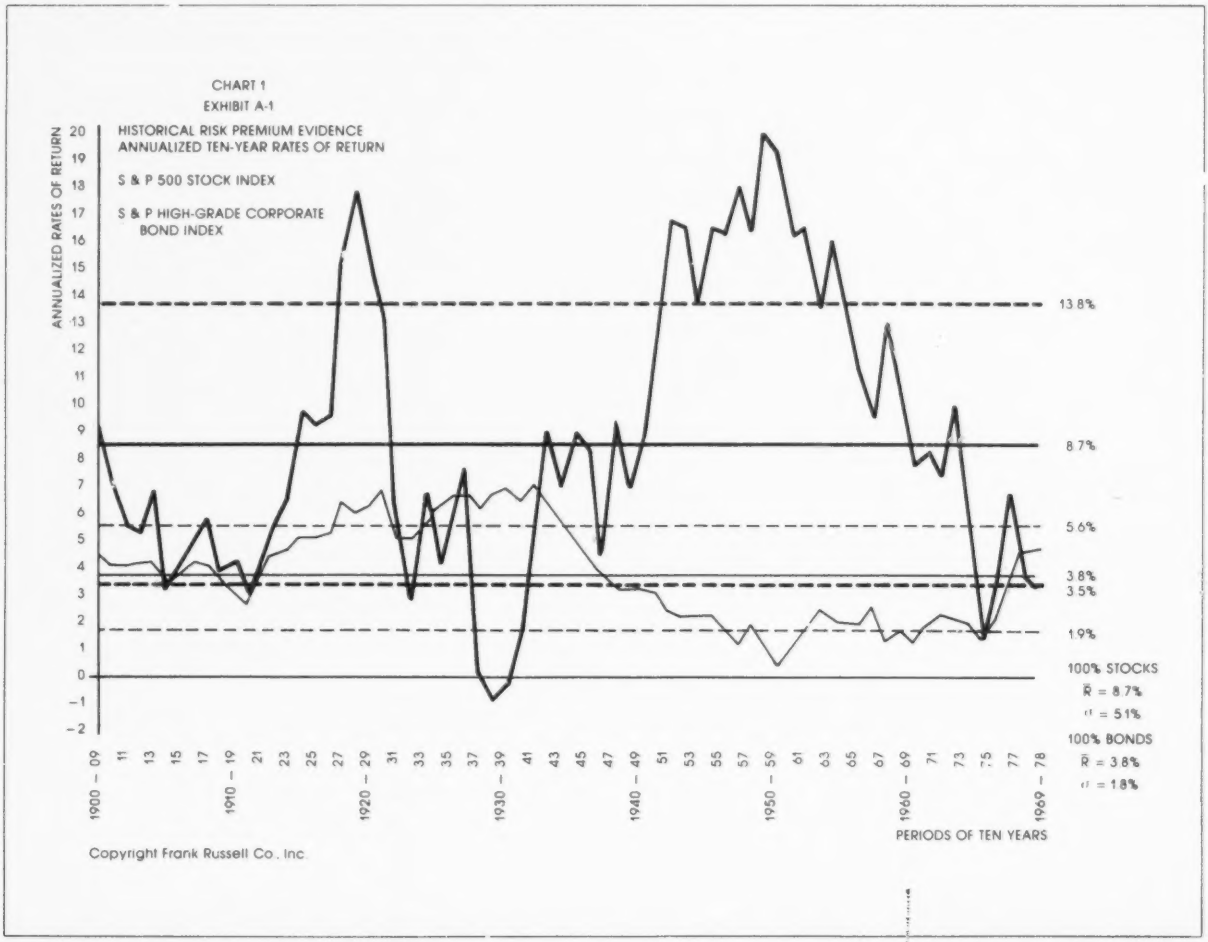
Are people who are so ready to abandon traditional prudent investing so sure of what the future holds that they assume inflation will vanish, or that prudently chosen equities will lose their superiority as an investment defense against inflation? From 1900-1978, the inflation-adjusted annualized 10-year rate of return on stocks has been 6 percent. The rate of return on fixed-income investment, again adjusted for inflation, has been only 1.3 percent. (Chart 2)[14]

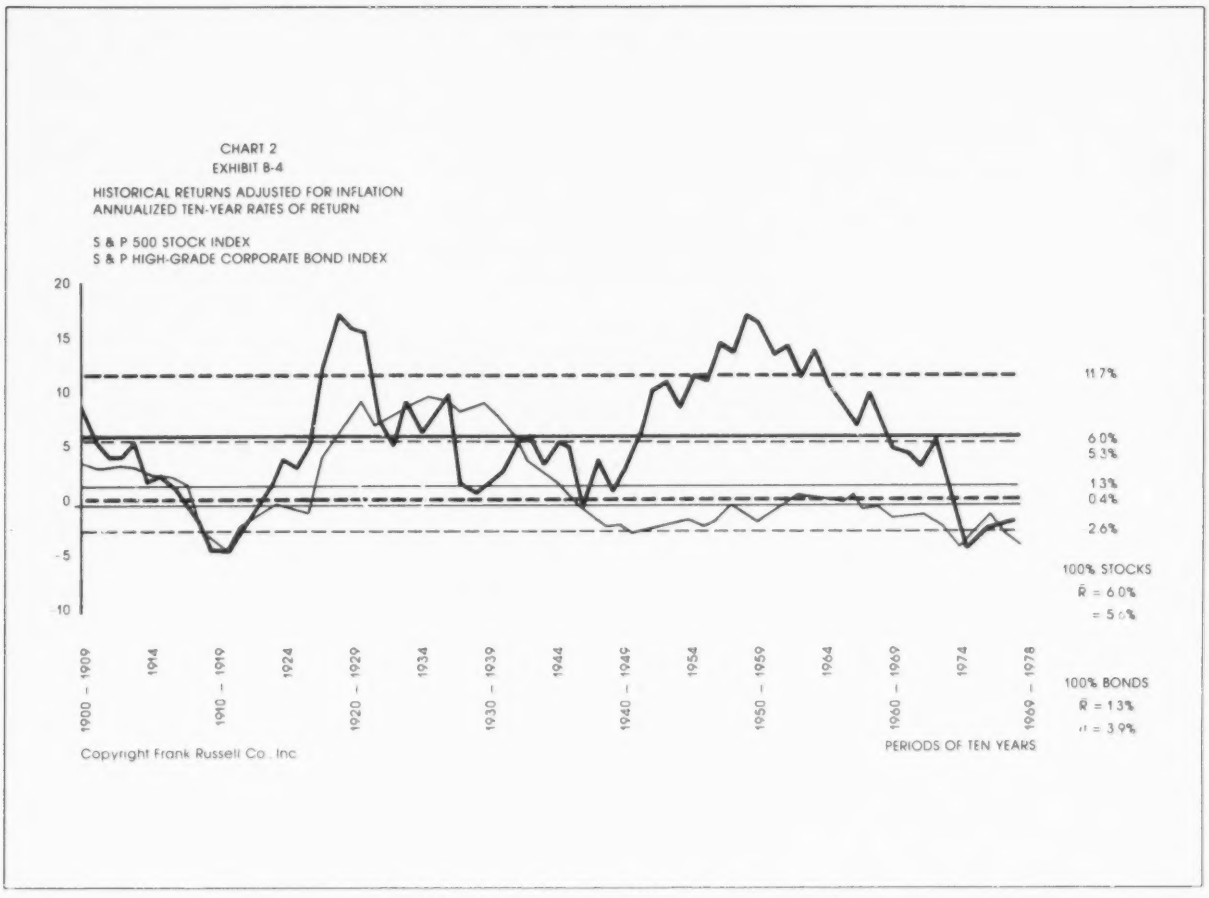
". . . Will Rogers said he was not as concerned about return on investment as return of investment . . ."

In short, advocacy of divergent investing would have less force if facts about traditional prudent investing were not used "selectively."

One other error compounding the smugness of hindsight about how prudent investing has performed is that relative riskiness is ignored. If a total portfolio's return has been, say, 6 percent, that is thought to justify loans to, say, small firms at about that same interest rate. Only a moment is needed for a disinterested observer to see that unless riskier investments earn higher yields to compensate for the greater risk taken and to help build a cushion against the higher number of disappointments bound to occur in that higher-risk area, the whole fund itself soon will be an acute disappointment.

When Will Rogers said that he was not as concerned about return on investment as about return *of* investment (a maxim that ought to be a legally required legend, in large type, on every page of every investment manager's merchandising materials), old Will





didn't mean what the advocates mean.

One final force fuels the advocacy of divergent investing. There always are people who need something to advocate, either because they are in the political arena, or just want to sound off.[15]

I don't fault such people. Political dialog should be wide open, and far be it from me, as a law professor, to be so graceless as to condemn others for seeking a podium. But not all divergent investing advocates are blameless. Some of them are hypocrites, urging that other people's funds be exploited in ways they wouldn't dream of allowing for their own.

I regret that the outstanding example of such hypocrisy involves the secretary-treasurer of a union, since I am pro-union and consider the Amalgamated Clothing and Textile Workers one of the finest in many ways. But how can we ignore the following contrast between advocacy and practice?

The advocacy:

"There are billions of dollars in the state employees' pension fund. Clearly these monies can be invested in any number of ways to secure an adequate rate of return. The best interests of the system's beneficiaries, however, extend far beyond the mere rate of return.

"Investment capital provides the necessary dollars for economic growth and development. The range of opportunities to deploy capital is broad, and the billions of dollars in the New York State Fund can have tremendous impact wherever those dollars are directed. We need to seriously consider these directions.

"Profitability cannot be the only criterion. Where are these investment dollars reinvested after they leave our hands? How much of the property on which the fund holds mortgages lies within New York State? How many of the corporations whose notes or stocks we hold conduct most of their business inside of New York? Each dollar invested in an enterprise outside of this state diminishes our efforts to create jobs and economic growth right here.

"We should demand to know why our pension fund invests in an office building in Washington, D.C., or a military base (?) in Kansas. The same rate of return can be found in numerous other investments without the same ultimate economic cost to our state."

"There always are people who need something to advocate . . ."

And here is the investment practice of that advocate union's pension fund, with assets of $237 million.

Of that $237 million, $4 million is in mortgages, $5 million is in insurance company guaranteed contracts, a tiny $800,000 is short-term, and the remainder has been invested — for so long that memory runneth not to the contrary — in U.S. government securities with five to 10-year maturities. (As one major trust department officer said, even more surprised by those maturities than by the portfolio concentration, "They're right-wingers. They don't even trust the government!")

Within recent months, that fund de-

cided it should utilize more fully the "broad range of opportunities to deploy capital," so it started modest acquisitions of GNMAs! Not even if that portfolio satisfies ERISA requirements of prudent diversification (and I am certain it does not, even though no court might be willing to hold trustees liable for investing exclusively in U.S. government securities), surely anyone involved with such a portfolio ought not advocate that other people's retirement security be jeopardized by indulgence in divergent investing. Never have I seen so literal an example of great distance between where the money is and where the mouth is.[17] □

FOOTNOTES

1. Use of the symbol "XX" is not meant to imply that such an investment has twice as much "bang," merely that it does have something extra.

Lest there be quibbling over what is the most accurate label in this discussion, I proposed at the EBRI discussion on December 6 that we use (1) "T" for traditional investing; (2) "XX" for what I call moderate divergent investing or what James Hutchinson refers to as "socially sensitive" investing (which troubled both Jeremy Rifkin, coauthor of *The North Will Rise Again*, and me); and (3) "X" or the recent favorite all-purpose label, "banana," for any investment which accepts possible or probable lower returns or higher risk.

In fact, I believe the "divergent" label is precisely accurate, and its accuracy accounts for its potency in piercing the euphemistic "social" label.

2. See my opening to "The Deregulation of the Banking and Securities Industries" (eds. Goldberg & White), *An Overview: New Myths and Old Realities*, (D.C. Heath, 1979).

3. See my testimony in Hearings on Investment Policies of Pension Funds, before Joint Economic Committee, Subcommittee on Fiscal Policy, 91st Cong. 2d Sess. (April 1970), pp. 110-34.

4. Starting last year, an inter-agency study led by the Department of Housing and Urban Development, being carried out by the Urban Institute and Municipal Finance Officers Association, includes an inquiry into state and local practices, law, and pressures related to alternative investing.

5. Wisconsin Center for Public Policy, *Investment Targeting: A Wisconsin Case Study* (1979), at 121. The remainder of this history, curiously omitting mention of the repeal, is at *id.*, pp. 16-17.

The report's advocacy of another try is a triumph of hope over experience. The study itself cost $180,000.

6. *Wisconsin Case Study, supra*, at 238.

7. Whether or not such "answers" are as neanderthal as I say, they reflect a deeper problem noted by Daniel Moynihan: "The difficulty is simply that a mind attuned to the market place acquires an almost trained insensitivity to nonmarket considerations." From his Arthur K. Solomon lecture, New York University School of Business, Apr. 29, 1971, p. 43.

8. A regional problem has been used as the fulcrum of a recent book devoted to divergent investing, the catchily-entitled *The North Will Rise Again*. As was said by a friendly reviewer in a friendly journal (Matt Witt, former editor of the *UMW Journal*, writing in *The New Republic*, Sept. 16, 1978, pp. 22-23), "This is not a book which should be judged on the fine print." A few examples and points should suffice to show that however noble the authors' goals, their work has such carelessness, inconsistency, and penchant for lamentation rather than analysis, facts, or prescriptions, as to render the book a disservice to its own cause.

(1) The main cry of the book is for union pension funds in "Graybelt" states to start investing locally. No attention is paid to: (a) What will happen if funds in the area growing more rapidly in wealth, the "Sunbelt," start pursuing the same policy? (Interestingly, earlier this year an investment management firm in Houston started offering a "Sunbelt Index Fund," based on data showing that equity investment there has considerably outperformed other equity investment.) (b) What will happen to Graybelt pension fund beneficiaries if their local investments perform poorly, or even just less well than more national (or international) investments? (c) Would such indirect support to the Graybelt economy be effective at all, let alone as effective as more direct steps such as regional development banks, ESOPs, pooled investment in inner cities, etc.? (d) To what extent are the problems of the Graybelt not even the result of capital shortage, but rather of a secular transition of the older part of the nation, a problem already enjoying substantial self-connection? (e) Don't the interests of marginal current workers, who might benefit from non-economic local investments, diverge from the interests of retirees and others who have vested stakes in the pension funds?

In response to concerns this book prompted among four Congressmen in the Northeast-Midwest Coalition, the Northeast-Midwest Institute did "research to analyze whether or not these claims [that their region is being "redlined" by pension fund capital] can be substantiated." The study concluded "that the above claims, on their face, are simplistic and misleading. The more accurate observation is that key factors such as relatively high costs of labor, land, transportation and energy have helped make the region less competitive." Anne Kaufman, *An Analysis of Current Issues in Pension Fund Investment Practices* (April 1979), p.1.

Thus even a source highly sympathetic to seeing "the North rise again," finds the book fallacious. Coming to the same conclusion after full economic analysis is George J. Borgas, *Union Control of Pension Funds: Will the North Rise Again?* (Inst. for Contemporary Studies, San Francisco, 1979).

Since it is not this paper's purpose to refute fantasy about regional economic cycles — by examining, e.g., such differences within the "North" as New Hampshire's sharp rise in contrast to Massachusett's problems, or why even the latter are turning around — the above references, citations therein, and the recent state-by-state study by Chicago's Harris Bank economists Genetski and Chin, should suffice.

(2) The book rests on the premise that our Federal union, with free flow of people, goods, services and funds throughout the nation, is less desireable than a Balkanized America. Not weighed and found wanting, but rather that the book ignores such facts of life. I'm with the majority who do not want to resurrect the Articles of Confederation.

(3) The book is closer to dream than reality. For example, the State of Pennsylvania did take special steps to aid the location there of a new VW assmbly plant. The book grossly overstates the state aid involved (the alleged $135 million loan is over two times the actual aid), and grossly understates the gain: "a measly 2,000 to 5,000 private-sector jobs." (p. 173).

(4) The book is strikingly slipshod. It says the generations-old "prudent man rule" is a "new term" introduced by ERISA, the 1974 Pension Reform Act (p. 102) and it cannot decide whether the funds it is discussing amount to $500 billion (p. 10), $406 billion (at book, or $438 billion at market, p. 234), $200 billion (pp. 10, 81), or $125 billion (p. 236).

(5) The book is so inconsistent as to be at war with itself. For example, it laments use by corporate pension sponsors of their pension assets for their corporate goals, but applauds state or local government use for governmental goals. State and local employees who are the beneficiaries of their employers' plans are evidently less worthy of concern than corporate employees. One of the clearest examples of the book's "wanting-it-both-ways" is this:

"Take, for example, the Wisconsin State Life Insurance fund. Founded as a self-supporting state-owned business in 1911, this insurance company provides Wisconsin residents with the least expensive life-insurance costs in the United States. . . . This incredible difference is partially a result of the fact that the Wisconsin Fund has such a small overhead compared to private insurance companies. Because it has no advertising costs and no sales commissions to pay out, its administrative expenses are virtually zero compared to industry giants like Prudential. Unfortunately, because of a strong lobby by the private insurance industry over the years, the fund has been unable to expand its mandate to cover larger premiums and to diversify into other insurance areas. As a result of that and its legal restrictions on advertising and solicitation, it has remained small." (p. 203).

9. John C. Bogle and Jan M. Twardowski, "Comparative Equity Investment Performance: Banks, Investment Counselors, Insurance Companies and Mutual Funds," forthcoming publication in *Financial Analysts Journal;* Investment Company Institute, Perspective on Mutual Fund Activity, Rpt. No. 4, Oct. 18, 1979, at 35-36, and ICI Associate Economist Jos. F. Sumanski, A Performance Comparison of Mutual funds and Bank-Pooled Funds, Nov. 21, 1979.

10. First, some of the data warrant explanation:

(1) It is unusually difficult to beat the S. & P., for many reasons not pertinent here. The point of Comparison A is rather how very wide is the margin between the pension funds and the mutual funds.

(2) The CDA data are annualized rates of total return, not the total return over the full 3-, 5-, or 10-year periods; and they are not medians but unweighted means.

(3) The "risk adjusted total return" ("alpha") figure states how good the actual performance was in light of how much, or how little, risk the fund(s) took on as compared to the whole market. The figure is arrived at as follows: "Riskless" return is the return on Treasury bills. If T-bills' total return was 8.6 percent for the year 6/30/78 to 6/30/79 (as it actually was), then that 8.6 percent is compared to the total return on the S. & P. 500 (as the proxy for the whole market) in order to derive the "market risk premium" an investor in equities received for taking on more risk. (In a bad year, the risk "premium" can be negative.) Thus since the S. & P.'s total return was 13.5 percent for 6/30/78 to 6/30/79, the "market risk premium" was 5 percent (actually 4.96 percent, the earlier figures being rounded).

If a fund or group of funds took on no more risk than the market generally (to state that in terms of one numerical measure, a "beta" of 1.0), the fund(s) would underperform or outperform the market simply by securing a total return under or over the market's. But if the fund(s) took on, say, ⅛ more riskiness than the market (a beta of 1.125), then the fund(s) should enjoy ⅛ more "risk premium" than the market's. Thus if the market as a whole returned 5 percent more than T-bills, the ⅛-riskier fund(s) should have a risk premium of 5.625 percent, or for 6/30/78 to 6/30/79, a total return of 14.225 percent.

Since the CDA equity mutual funds were ⅛ riskier than the market but had a total return of 15.6 percent, they exceeded by 1.375 percent their expected reward for the riskiness they assumed. On the other hand, the CDA bank pools, which took on only 95 percent as much risk as the whole market, were expected to have a "risk premium" of 4.75 percent above T-bills, or a total return for 6/30/78 to 6/30/79, of 13.35 percent. Since in fact those pooled funds returned only 13.0 percent, they had a negative risk-adjusted total return of 0.35 percent.

(4) The CDA bank pools are not under as great diversity of management as the Becker universe. Similarly, the Lipper group of mutual funds are probably more diverse, in terms of kinds of managements involved, than the earlier Becker groups, since such large portions of the latter were managed by a relatively small number of huge bank